

FORMULA SYSTEMS (1985) LTD
Form 20-F
June 30, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Date of event requiring this shell company report _____

Commission File Number: 0-29442

FORMULA SYSTEMS (1985) LTD.

(Exact Name of Registrant as Specified in Its Charter)

Israel

(Jurisdiction of Incorporation or Organization)

3 Abba Eban Boulevard, Herzlia 46725, Israel

(Address of Principal Executive Offices)

Guy Bernstein, CEO, 3 Abba Eban Boulevard, Herzliya 46725, Israel

Tel: 972 9 9598800, Fax: 972 9 9598877

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

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

Title of each class
Ordinary Shares, NIS 1 par value

Name of each exchange on which registered
Tel Aviv Stock Exchange

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American Depositary Shares

NASDAQ Global Market

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

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

As of December 31, 2007, the registrant had 13,200,000 outstanding ordinary shares, NIS 1 par value, of which 347,417 were represented by American depositary shares as of such date.

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

Yes No

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

Yes No

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

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

US GAAP

International Financial Reporting Standards as issued by the International Accounting Standards Board

Other

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

Item 17 Item 18

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

Yes No

PART I

Some of the statements in this annual report, including those in the Risk Factors, Item 3. Key Information Risk Factors, Item 4 Information on the Company Business Overview and Item 5 Operating and Financial Review and Prospects, are forward-looking statements that involve risks and uncertainties. These forward-looking statements include statements about our plans, objectives, strategies, expectations, intentions, future financial performance and other statements that are not historical facts. We use words like anticipates, believes, expects, future, intends and similar expressions to mean that the statement is forward-looking. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the United States, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

We have based these forward-looking statements on our current expectations and projections about future events. You should not unduly rely on these forward-looking statements, which apply only as of the date of this annual report. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including the risks described in Item 3. Key Information Risk Factors.

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States, commonly referred to as U.S. GAAP. In accordance with U.S. GAAP, we use the United States dollar as our reporting currency. In accordance with FASB Statement of Financial Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets, and following the distribution of the shares held by Formula in Formula Vision Technologies (F.V.T.) Ltd., or Formula Vision, as a dividend to Formula's shareholders, in December 2006 and the sale of our entire shareholdings in BluePhoenix Solutions Ltd., or BluePhoenix, in June 2007, Formula Vision's and BluePhoenix's results of operations, assets and liabilities were classified as attributed to discontinued operations and as a result, we have restated certain figures in our financial statements relating to prior periods.

As used in this annual report, references to dollar refer to the United States dollar and references to NIS refer to New Israeli Shekels. References to the Israeli consumer price index refer to the Israeli CPI.

As used in this annual report, references to we, our, ours and us refer to Formula Systems (1985) Ltd. and its subsidiaries, unless otherwise indicated. References to Formula refer to Formula Systems (1985) Ltd.

All trademarks appearing in this annual report are the property of their respective holders.

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ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION**A. Selected Financial Data**

The following tables present our consolidated statement of operations and balance sheet data for the periods and as of the dates indicated. We derive the consolidated statement of operations data for the years ended December 31, 2005, 2006 and 2007, and the balance sheet data as at December 31, 2006 and 2007 from our consolidated financial statements included elsewhere in this annual report. Our consolidated financial statements have been audited by Ziv Haft registered public accounting firm, BDO member firm. The consolidated income statement data for the years ended December 31, 2003 and 2004 and the consolidated balance sheet data for the years ended December 31, 2003, 2004 and 2005 are derived from our audited financial statements not included in this annual report. You should read the selected consolidated financial data together with our consolidated financial statements included elsewhere in this annual report. See Item 5. Operating and Financial Review and Prospects.

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	Year Ended December 31,				
	2007	2006	2005	2004	2003
	\$				
	(In thousands, except per share data)				
Consolidated Statement of Operations Data:					
Revenues	\$ 493,350	\$ 416,807	\$ 365,841	\$ 332,279	\$ 304,542
Cost of revenues	369,110	309,447	266,234	228,216	204,759
Gross profit	124,240	107,360	99,607	104,063	99,783
Research and development costs, net	6,547	5,508	6,094	5,813	8,028
Selling, general and administrative expenses	90,458	88,844	86,682	82,548	84,168
Restructuring and non-recurring costs	--	2,911	1,455	--	--
Operating income	27,235	10,097	5,376	15,702	7,587
Financial expenses, net	(3,810)	(4,660)	(2,059)	(4,888)	(3,810)
Gain on realization of shareholdings, net	2,039	3,724	3,192	8,170	2,379

ITEM 3. KEY INFORMATION

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In June 2005, Formula distributed to its shareholders a cash dividend of approximately \$4 per share. The aggregate amount distributed by Formula was approximately \$50.2 million.

Under Formula's dividend policy adopted by its board of directors, sums that are not planned to be used for investments in the near future, will be distributed to the shareholders as a cash dividend, to the extent that our performance allows such distribution.

Cash dividends may be declared and paid in New Israeli Shekels or dollars. Dividends to the holders of the American Depositary Receipts, or ADRs, are paid by the depositary of the ADRs, for the benefit of owners of ADRs. If the dividend is declared and paid in NIS, the NIS amount is converted into dollars by the depositary of the ADRs.

Dividends paid by an Israeli company to shareholders residing outside Israel, holding less than 10% of the outstanding share capital of the company, are generally subject to withholding of Israeli income tax at a rate of up to 20%. Shareholders holding 10% or more of our outstanding share capital shall generally be subject to withholding of Israeli income tax at a rate of up to 25% on dividends. Such tax rates apply unless a lower rate is provided in a treaty between Israel and the shareholder's country of residence.

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Our business, operating results and financial condition could be seriously harmed due to any of the following risks. Additional risks and uncertainties that we are not aware of or that we currently believe are immaterial may also adversely affect our business, financial condition, results of operations and our liquidity. In addition, the trading price of our ordinary shares could decline due to any of these risks, and you may lose all or part of your investment.

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Risks Relating to Our Business

We may experience significant fluctuations in our annual and quarterly results, which makes it difficult for investors to make reliable period-to-period comparisons and may contribute to volatility in the market price for our ordinary shares and American Depositary Shares.

Our quarterly and annual revenues, gross profits and results of operations have fluctuated significantly in the past, and we expect them to continue to fluctuate significantly in the future. The following events may cause fluctuations:

acquisitions and dispositions of companies and consolidation of our subsidiaries;

the size, time and recognition of revenue from significant contracts;

timing of product releases;

timing of contracts;

timing of completion of specified milestones and delays in implementation;

changes in the proportion of service and license revenues;

price and product competition;

increases in selling and marketing expenses, as well as other operating expenses;

currency fluctuations; and

consolidation of our customers.

A substantial portion of our expenses, including most product development and selling and marketing expenses, must be incurred in advance of when revenue is generated. If our projected revenue does not meet our expectations, we are likely to experience an even larger shortfall in our operating profit relative to our expectations. The gross margins of our subsidiaries also will vary both among themselves and over time. As a result, changes in the revenue mix from these subsidiaries may affect quarterly operating results. In addition, we may derive a significant portion of our net income from transactions which involve equity issuances by our subsidiaries, the sale of equity securities of our subsidiaries or the sale of proprietary software technology. These events do not occur on a regular basis and their timing is difficult to predict. As a result, we believe that period-to-period comparisons of our historical results of operations are not necessarily meaningful and that you should not rely on them as an indication for future performance. Also, it is possible that our quarterly and annual results of operations may be below the expectations of public market analysts and investors. If this happens, the price of our ordinary shares will likely decrease.

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If capital spending on information technology, or IT, slows down, our business could be seriously harmed.

We are affected by global economic changes, in particular trends in capital spending in the IT sector. Changes in purchasing patterns in the IT industry directly affect our operating results. Economic changes such as the U.S. subprime mortgage loan crisis and the economic instability caused by the rise in oil prices, are affecting companies' willingness, in both the U.S. and in Europe, to make capital spending on IT projects. In addition, many of our customers are in the financial sector. A slow-down in the financial markets may affect these customers' willingness to make capital spending on IT projects. We cannot know whether IT capital spending and investment in IT projects will continue in the future at the same level, or how the economic conditions will affect our business. Accordingly, we cannot assure you that we will be able to increase our revenues or keep our revenues at the same level as in 2007.

Our success depends upon the development and maintenance of strategic alliances.

We established relationships with strategic partners to provide international marketing presence and name recognition, as well as the resources necessary to implement many of our IT services. We are dependent upon our strategic partners for the marketing and selling of certain of our proprietary software solutions. If we cannot maintain our existing relationships with these partners or if we fail to establish effective, long-term relationships with additional partners, or if our partners enter into relationships with our competitors, our ability to market our proprietary software solutions in international markets may be limited. If this happens, our growth, if any, might be delayed or slowed-down. As a result, our business, financial condition, and results of operations could be seriously harmed.

If our products fail to compete successfully with those of our competitors, we may have to reduce the prices of our products, which in turn, may adversely affect our business.

We face competition, both in Israel and internationally, from a variety of companies, including companies with significantly greater resources than us who are likely to enjoy substantial competitive advantages, including:

longer operating histories;

greater financial, technical, marketing and other resources;

greater name recognition;

well-established relationships with our current and potential clients; and

a broader range of products and services.

As a result, they may be able to respond more quickly to new or emerging technologies or changes in customer requirements. They may also benefit from greater purchasing economies, offer more aggressive product and service pricing or devote greater resources to the promotion of their products and services. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase such competitors' ability to successfully market their tools and services. We also expect that competition will increase as a result of consolidation within the industry. We also face additional competition as we continue to penetrate international markets. As a result, we cannot assure you that the products and solutions we offer will compete successfully with those of our competitors.

We may be unable to differentiate our tools and services from those of our competitors or successfully develop and introduce new tools and services that are less costly than, or superior to, those of our competitors. This could have a material adverse effect on our ability to compete.

Furthermore, several software development centers worldwide offer software development services at lower prices than we do. Due to the intense competition in the markets in which we operate, software products prices may fluctuate significantly. As a result, we may have to reduce the prices of our products, which in turn, may adversely affect our business.

If we fail to compete for acquisitions and investments, we may be unable to grow.

As part of our strategy, we intend to pursue acquisitions of, and investments in, other companies. If and when acquisition or investment opportunities occur, we expect to compete for these opportunities with other established and well-capitalized entities. We cannot assure you that we will be able to locate potential acquisition or investment opportunities in Israel or internationally on terms which are favorable to us. If we fail to consummate further acquisitions or investments in the future our ability to grow may be harmed.

Any future acquisitions of companies or technologies may distract our management and disrupt our business.

Our strategy includes selective acquisitions of, and investments in, companies offering products and services suitable for integration into our business. We may acquire or make investments in complementary businesses, technologies, services or products if appropriate opportunities arise. We may engage in discussions and negotiations with companies about our acquiring or investing in those companies' businesses, products, services or technologies. We cannot assure you that we will be able to identify future suitable acquisition or investment candidates, or if we do identify suitable candidates, that we will be able to make the acquisitions or investments on commercially acceptable terms or at all. If we acquire or invest in another company, or if any of our subsidiaries acquires control in another subsidiary or affiliate, the acquirer could have difficulty assimilating that company's personnel, operations, technology or products and service offerings into its own. The key personnel of the acquired company may decide not to work for the acquirer. These difficulties could disrupt our ongoing business, distract our management and employees, increase our expenses and adversely affect our results of operations. We may incur indebtedness or issue equity securities to pay for any future acquisitions. The issuance of equity securities could be dilutive to our existing shareholders.

We intend to pursue acquisitions outside of Israel as part of our expansion strategy. These acquisitions, as well as any future acquisitions of companies located outside of Israel, would pose additional risks, including monitoring a management team from a great distance and integrating a potentially different business culture. Our failure to successfully integrate these new businesses could harm our business. In addition, the investigation of acquisition candidates outside of Israel involves higher costs than those associated with pursuing domestic acquisitions, and we cannot assure you that these investigations will result in transactions.

Certain amounts have been allocated to goodwill on our balance sheet as a result of acquisitions made by us from time to time and should it become necessary to write-off a material part of this, our results of operations could be materially adversely affected.

We acquire businesses from time to time and as a result, certain amounts have been allocated to goodwill on our balance sheet. Goodwill and other intangible assets that have indefinite useful lives are tested at least annually for impairment. Should a test disclose that there has been a permanent impairment of a material part of the value of goodwill, it would be necessary to write-off such amount, and this could materially adversely affect our results of operations.

If we fail to raise capital for our subsidiaries, we may be required to borrow money on unfavorable terms.

Our business strategy involves raising capital for our subsidiaries through public or private offerings. Our ability to raise capital for our subsidiaries depends upon market and other conditions which are beyond our control. If we fail to raise capital for our subsidiaries, it may hinder their growth. We may therefore be required to seek alternative capital raising methods, including borrowing money on terms which are not favorable to us. In the last few years, due to difficulties we encountered in raising capital for our subsidiaries, we were required to borrow monies from banks. Difficulties in raising capital on favorable terms, may materially and adversely affect our business, operating results and financial condition.

The terms of our credit facilities contain a number of restrictive covenants which, if breached, could result in acceleration of our obligation to repay our debt.

The loan agreements of our subsidiaries contain a number of conditions and limitations on the way in which they can operate their business, including limitations on their ability to raise debt and sell or acquire assets. These loan agreements also contain various covenants which require them to maintain certain financial ratios related to shareholders' equity and operating results that are customary for companies of comparable size. These limitations and covenants may force us to pursue less than optimal business strategies or forego business arrangements which could have been financially advantageous to us or to our shareholders.

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Marketing our products and services in international markets may require increased expenses and greater exposure to risks that we may not be able to successfully address.

We intend to continue to focus our efforts on selling proprietary software solutions in international markets. We expect to continue devoting significant resources to these efforts. If we are unable to continue achieving market acceptance for our solutions or otherwise continue to successfully penetrate international markets, our business will be harmed. In 2006 and 2007, we received approximately 37% and 35% of our total revenues, respectively, from customers located outside of Israel. The expansion of our existing operations and entry into additional international markets will require significant management attention and financial resources. We are subject to a number of risks customary for international operations, including:

- changing product and service requirements in response to the formation of economic and marketing unions, including the European Union;
- economic or political changes in international markets;
- greater difficulty in accounts receivable collection and longer collection periods;
- unexpected changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;
- the uncertainty of protection for intellectual property rights in some countries;
- multiple and possibly overlapping tax structures; and
- currency and exchange rate fluctuations.

If we fail to address the strain on our resources caused by changes in our company, we will be unable to effectively manage our business.

Corporate organizational changes, as well as growth of our business, if any, have placed and will continue to place a strain on our personnel and resources. Our ability to manage any future changes or growth, depends on our ability to continue to implement and improve our operational, financial and management information control and reporting systems on a timely basis and to expand, train, motivate and manage our work force. If we cannot respond effectively to changing business conditions, our business, financial condition and results of operations could be materially adversely affected.

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If we are unable to attract, train and retain qualified personnel, we may not be able to achieve our objectives and our business could be harmed.

In order to achieve our objectives, we may need to hire additional qualified software, administrative, operational, sales and technical support personnel. The process of attracting, training and successfully integrating qualified personnel into our operations can be lengthy and expensive. We may not be able to compete effectively for the personnel we need. Our future success depends on our ability to absorb and retain senior employees and to attract, motivate and retain highly qualified professional employees. We expect to recruit most of our software and systems personnel in Israel. As part of our growth strategy, we developed offshore centers in India. We hired professional consultants for these development centers, leveraging the lower employer costs that existed in this country. Recently, professional work in India became more expensive and professional fees may continue to increase in the future. We cannot assure you that our offshore facilities will be profitable. In addition, our operations are dependent on the efforts of certain key management. Any loss of members of senior management or key technical personnel, or any failure to attract or retain highly qualified employees as needed, could materially adversely affect our business.

If we fail to estimate accurately the costs of fixed-price contracts, we may incur losses.

We derive a portion of our revenues from engagements on a fixed-price basis. We price these commitments upon estimates of future costs. We bear the risk of faulty estimates and cost overruns in connection with these commitments. Our failure to accurately estimate the resources required for a fixed-price project, to accurately anticipate potential wage increases, or to complete our contractual obligations in a manner consistent with the project plan could materially adversely affect our business, operating results, and financial condition. In addition, we may agree to a price before the design specifications are finalized, which could result in a fixed price that is too low, resulting in lower margins or losses to us.

If our tools or solutions do not function efficiently, we may incur additional expenses.

In the course of providing our software solutions, we conduct testing to detect the existence of failures, errors and bugs. In addition, we have instituted a quality assurance procedure for correcting errors and bugs in our tools. The amount of failures, errors and bugs detected to date, and the cost of correcting them, have not been significant. However, if our solutions fail to function efficiently or if errors or bugs are detected in our tools, we might incur significant expenditures in an attempt to remedy the problem. The consequences of failures, errors, and bugs could have a material adverse effect on our business, operating results, and financial condition.

If we fail to satisfy our customers' expectations regarding our solutions, our contracts may be cancelled and we may be the subject of damages claims.

In the event that we fail to satisfy our customers' expectations from the results of the implementation of our solutions, or if we fail to timely deliver our solutions to our customers, these customers may suffer damages. When and if this occurs, customers may have the ability to cancel our contracts. Any cancellation of a contract could cause us to suffer damages, since we might not be paid for costs that we incurred in performing services prior to the date of cancellation. In addition, from time to time we may be subject to claims as a result of not delivering our products on time or in a satisfactory manner. Such claims may lead to material damages.

If we are unable to accurately predict and respond to market developments or demands, our business will be adversely affected.

The IT business is characterized by rapidly evolving technology and methodologies. This makes it difficult to predict demand and market acceptance for our services and products. In order to succeed, we need to adapt the products and services we offer to technological developments and changes in customer needs. We cannot guarantee that we will succeed in enhancing our products and services or developing or acquiring new products and services that adequately address changing technologies and customer requirements. We also cannot assure you that the products and services we offer will be accepted by customers. If our products and services are not accepted by customers, our future revenues and profitability will be adversely affected. Changes in technologies, industry standards, the regulatory environment, customer requirements and new product introductions by existing or future competitors could render our existing products and services obsolete and unmarketable, or require us to enhance our current products or develop new products. This may require us to expend significant amounts of money, time and other resources to meet the demand. This could strain our personnel and financial resources.

If we are unable to retain control in our subsidiaries, we would cease to consolidate them and our operating results may fluctuate significantly.

We currently hold a controlling interest in our subsidiaries through our direct equity holdings. From time to time, if and when required, we enter into voting agreements with other shareholders of the companies, in order to retain control of our subsidiaries. As a result of our controlling interests in the subsidiaries, we consolidate their operating results with ours. If we are unable to maintain a controlling interest in our subsidiaries, as a result of equity issuances by subsidiaries, failure to reach voting agreements or otherwise, we would cease to consolidate the operating results of these subsidiaries. This may result in significant fluctuations of our consolidated operating results.

We are exposed to significant claims for damage caused to our customers' information systems.

Some of the products and services we provide involve key aspects of customers' information systems. These systems are frequently critical to our customers' operations. As a result, our customers have a greater sensitivity to failures in these systems than do customers of other software products generally. If a customer's system fails during or following the provision of products or services by us, or if we fail to provide customers with proper support for our software products, we are exposed to the risk of a claim for substantial damages being filed against us, regardless of our responsibility for the failure. When possible, we limit our liability under our product and service contracts. We cannot guarantee that these limitations of liability, if any, would be sufficient to protect us against legal claims. We maintain general liability and professional liability insurance coverage. However, we cannot assure you that our insurance coverage will be sufficient to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. If we lose one or more, large claims against us that exceed available insurance coverage, our business, operating results and financial condition may be materially adversely affected. In addition, the filing of legal claims against us in connection with contract liability may cause us negative publicity and damage to our reputation.

If third parties assert claims of infringement against us, we may suffer substantial costs and diversion of management's attention.

Substantial litigation over intellectual property rights exists in the software industry. We expect that software products may be increasingly subject to third-party infringement claims as the functionality of products in different industry segments overlaps. We cannot predict whether third parties will assert claims of infringement against us. In addition, our employees and contractors have access to software licensed by us from third parties. A breach of the non-disclosure undertakings by any of our employees or contractors may lead to a claim of infringement against us. Any claim, with or without merit, could be expensive and time-consuming to defend, and would probably divert our management's attention and resources. In addition, such a claim if submitted may require us to enter into royalty or licensing agreements to obtain the right to use a necessary product or component. Such royalty or licensing agreements, if required, may not be available to us on acceptable terms, if at all.

A successful claim of product infringement against us and our failure or inability to license the infringed or similar technology could have a material adverse effect on our business, financial condition and results of operations.

We may be unable to adequately protect our proprietary rights, which may limit our ability to compete effectively.

Our success and ability to compete are substantially dependent upon our internally developed technology. Substantially all of our intellectual property consists of proprietary or confidential information that is not subject to patent or similar protection. In general, we have relied on a combination of technical leadership, trade secret, copyright and trademark law and nondisclosure agreements to protect our proprietary know-how. Unauthorized third parties may attempt to copy or obtain and use the technology protected by those rights. Any infringement of our intellectual property could have a material adverse effect on our business, financial condition and results of operations. Policing unauthorized use of our products is difficult and costly, particularly in countries where the laws may not protect our proprietary rights as fully as in the United States. We have placed, and in the future may place, certain of our software in escrow. The software may, under specified circumstances, be made available to our customers. From time to time, we also provide our software directly to customers. This may increase the likelihood of misappropriation or other misuse of our software.

Our largest shareholder, Emblaze Ltd., owns the majority of our ordinary shares and controls the outcome of matters that require shareholder approval.

Emblaze Ltd., or Emblaze, owns approximately 50.1% of our outstanding ordinary shares. Therefore, Emblaze has the power to control the outcome of those matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This share ownership may have the effect of delaying or preventing a change in control. In addition, potential conflicts of interest may arise in the event that we enter into agreements or transactions with affiliates of Emblaze. Although Israeli law imposes certain procedures (including shareholder approval) for approval of certain related party transactions, we cannot assure you that these procedures will eliminate the possible

detrimental effects of these conflicts of interest. If certain transactions are not approved in accordance with required procedures under applicable Israeli law, these transactions may be void or voidable.

Fluctuations in foreign currency values affect the prices of our products, which in turn may affect our business and results of operations.

A significant portion of our worldwide sales are currently denominated in dollars and euros, while a substantial portion of our expenses, principally salaries and related personnel expenses, are in New Israeli Shekels (NIS). As a result, a decrease in the value of the dollar or euro relative to other foreign currencies, in particular the NIS would increase our operating costs and, therefore, could adversely affect our results and harm our competitive position in the markets. In recent periods, the value of the dollar and the euro was decreased significantly in relation to the NIS. We cannot know whether this trend would continue in the future. If the dollar or euro value in relation to the NIS continues to decrease, our operating costs would increase, and in turn, our results of operation may be harmed. To date, we have not engaged in significant hedging transactions. In the future, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar or euro against the NIS. However, we cannot assure you that these measures will adequately protect us from material adverse effects arising from the impact of inflation in Israel. For additional information relating to the exchange rates between different relevant currencies, see Item 5. Operating and Financial Review and Prospects Overview Our Functional and Reporting Currency.

We may be adversely affected if the market prices of our publicly traded subsidiaries decrease.

A significant portion of our assets is comprised of equity securities of publicly and non-publicly traded companies. Our publicly traded subsidiaries are Magic Software Enterprises Ltd., Matrix IT Ltd. and Sapiens International Corporation N.V. The stock prices of these publicly traded companies have been extremely volatile, and have experienced fluctuations due to market conditions and other factors which are beyond our control. Fluctuations in the market price and valuations of our holdings in these companies may affect the value of our assets. In addition, the stock prices of many technology companies fluctuate significantly for reasons that may be unrelated to operating results. If the value of our assets decreases significantly as a result of the above, our business, operating results and financial condition, may be materially and adversely affected.

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Risks Related to our Traded Securities

The market price of our ordinary shares and American Depositary Shares may be volatile and you may not be able to resell your shares at or above the price you paid, or at all.

The stock market in general has experienced during recent years extreme price and volume fluctuations. The market prices of securities of technology companies have been extremely volatile, and have experienced fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market fluctuations could adversely affect the market price of our ordinary shares and American Depositary Shares, or ADSs.

The high and low market price of our ordinary shares traded on the Tel Aviv Stock Exchange, or the TASE, under the symbol FORT, and the high and low market price of our ADSs traded on the Nasdaq Global Market, under the symbol FORTY during each of the last three years, are summarized in the table below:

	Nasdaq Global Market In \$		TASE In NIS	
	High	Low	High	Low
2007	14.46	11.69	60.59	44.97
2006	14.00	9.15	60.15	39.99
2005	20.44	9.92	89.65	46.80

The market price of the ordinary shares and the ADSs may fluctuate substantially due to a variety of factors, including:

any actual or anticipated fluctuations in our or our competitors' quarterly revenues and operating results;

shortfalls in our operating results from levels forecast by securities analysts;

public announcements concerning us or our competitors;

results of integrating investments and acquisitions;

the introduction or market acceptance of new service offerings by us or our competitors;

changes in product pricing policies by us or our competitors;

changes in security analysts' financial estimates;

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changes in accounting principles;

sales of our shares by existing shareholders; and

the loss of any of our key personnel.

In addition, economic, political and market conditions and military conflicts and in particular, those specifically related to the State of Israel, may affect the market price of our shares and ADSs.

Future sales of our shares in the public market or issuances of additional securities could cause the market price for our ordinary shares and ADSs to fall.

As of June 20, 2008, we had 13,200,000 ordinary shares outstanding, of which 315,542 were represented by ADSs. Of the 13,200,000 shares outstanding, 6,613,400 shares are held by Emblaze, our controlling shareholder. If a large number of our ordinary shares is sold in a short period, the price of our ordinary shares would likely decrease.

Our shares are traded on more than one market and this may result in price variations.

Our ordinary shares are traded on the TASE and our ADRs are traded on the NASDAQ Global Market. Trading in our ordinary shares and ADRs on these markets takes place in different currencies (dollars on the NASDAQ Global Market and NIS on the TASE), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). The trading prices of our ordinary shares and ADRs on these two markets may differ due to these and other factors. Any decrease in the trading price of our ordinary shares or ADRs, as applicable, on one of these markets could cause a decrease in the trading price on the other market.

Our United States investors could suffer adverse tax consequences if we are characterized as a passive foreign investment company.

Although we do not believe that we were a passive foreign investment company, or PFIC, for U.S. federal income tax purposes during 2007, we cannot assure you that we will not be treated as a passive foreign investment company in 2008 or in future years. We would be a passive foreign investment company if 75% or more of our gross income in a taxable year is passive income. We would also be a passive foreign investment company if at least 50% of our assets in a taxable year produce, or are held for the production of, passive income. Passive income includes interest, dividends, royalties, rents and annuities. If we are or become a passive foreign investment company, United States investors could be subject to adverse tax consequences, including having gain realized on the sale of our ordinary shares or ADSs being treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges apply to such sale proceeds. Rules similar to those applicable to gains derived from the disposition of our ordinary shares also apply to certain excess distributions. A decline in the value of our ordinary shares or ADSs may result in our being a PFIC. United States investors should consult with their own tax advisors with respect to the United States tax consequences of investing in our ordinary shares.

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For a discussion of how we might be characterized as a PFIC and related tax consequences, see Item 10. Additional Information Taxation United States Federal Income Tax Considerations.

Risks Relating to Operations in Israel

Political, economic, and military conditions in Israel could negatively impact our business.

Our headquarters and principal research and development facilities are located in Israel. Although we generated approximately 35% of our revenues in 2007 from international markets, we are, nonetheless, directly influenced by the political, economic and military conditions affecting Israel. Over the past several decades, a number of armed conflicts have occurred between Israel and its Arab neighbors. Major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, operating results, and financial condition. Since September 2000, there has been a high level of violence between Israel and the Palestinians. Hamas, an Islamist movement responsible for many attacks, including missile strikes against Israelis, won the majority of the seats in the Parliament of the Palestinian Authority in January 2006 and took control of the entire Gaza Strip, by force, in June 2007. These developments have further strained relations between Israel and the Palestinian Authority. Further, in the summer of 2006, Israel engaged in a war with Hezbollah, a Lebanese Islamist Shiite militia group, which involved thousands of missile strikes and disrupted most day-to-day civilian activity in northern Israel. Any armed conflicts, terrorist activities, or political instability in the region, may affect Israel's security, foreign relations, and the stability of the region. Increased hostilities, future armed conflicts, political developments in other states in the region, or continued or increased terrorism could make it more difficult for us to conduct our operations in Israel, which could increase our costs and adversely affect our financial results. Major hostilities involving Israel, including as a result of the military conflicts between the Fatah and Hamas in Gaza Strip, Judea and Samaria, or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, operating results and financial condition. Furthermore, several countries restrict business with Israeli companies. In addition, nonexempt male adult citizens of Israel, including some of our officers and employees, are obligated to perform military reserve duty until the age of 40 or 45 depending on their function in the army, and are subject to being called for active duty under emergency circumstances. While we have operated effectively under these requirements since our incorporation, we cannot predict the full impact of such conditions on it in the future, particularly if emergency circumstances occur. If many of our employees are called for active duty, our operations in Israel and our business may be adversely affected.

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The tax benefits available to us from government programs may be discontinued or reduced at any time, which would likely increase our taxes.

Certain of our subsidiaries received grants in the past and receive tax benefits under Israeli government programs, particularly as a result of the Approved Enterprise status of certain operations in Israel. Approved Enterprise status is granted by the Israeli Investment Center of the Ministry of Industry and Trade and entitles the grantee to a variety of tax incentives. The incentives awarded to certain of our subsidiaries include reduced tax rates and a tax holiday. Subject to compliance with applicable requirements, the portion of our subsidiary's undistributed income derived from our Approved Enterprise programs was exempt from income tax during the first two years, followed by a five year tax reduced tax rate of 25% instead of 27% on income derived from Approved Enterprise investment programs. In order to qualify for these incentives, the Approved Enterprise is required to provide minimum paid-in-capital (30% of the investment), to show an increase in its export activities, and to meet other general investing criteria. As of June 20, 2008, our subsidiaries have met those criteria and received tax benefits from their Approved Enterprise programs, as presented in Note 14 to our financial statements. To maintain the eligibility for these programs and benefits, we must meet the conditions mentioned above. We cannot assure you that these programs and tax benefits will continue at the same level in the future. If these tax benefits and programs are terminated or reduced, we could pay increased taxes in the future, which could decrease our profits.

It may be difficult to serve process and enforce judgments against our directors and officers in Israel.

We are organized under the laws of the State of Israel. All of our executive officers and directors are nonresidents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult to:

effect service of process within the United States on us or any of our executive officers or directors;

enforce court judgments obtained in the United States including those predicated upon the civil liability provisions of the United States federal securities laws, against us or against any of our executive officers or directors, in the United States or Israel; and

bring an original action in an Israeli court against us or against any of our executive officers or directors to enforce liabilities based upon the United States federal securities laws.

Provisions of Israeli law may delay, prevent or make more difficult an acquisition of us.

The Israeli Companies Law generally requires that a merger be approved by the board of directors and a majority of the shares voting on the proposed merger. For purposes of the shareholder vote, unless a court rules otherwise, the merger will not be deemed approved if shares representing a majority of the voting power present at the shareholders meeting, and which are not held by the other party to the merger (or by any person who holds 25% or more of the shares or the right to appoint 25% or more of the directors of the other party or its general manager) have voted against the merger. Upon the request of any creditor of a party to the proposed merger, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of the surviving company. Finally, a merger may generally not be completed unless at least (i) 50 days have passed since the filing of a merger proposal signed by both parties with the Israeli Registrar of Companies; and (ii) 30 days have passed since the merger was approved by the shareholders of each of the parties to the merger. Also, in certain circumstances an acquisition of shares in a public company must be made by means of a tender offer. Lastly, Israeli tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company, less favorably than U.S. tax laws. These provisions of Israeli corporate and tax law may have the effect of delaying, preventing or make more difficult an acquisition of or merger with us, which may adversely affect its ability to engage in a business combination and could depress our share price.

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As a foreign private issuer whose shares are listed on the NASDAQ Global Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.

As a foreign private issuer whose shares are listed on the NASDAQ Global Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules. A foreign private issuer that elects to follow a home country practice instead of such requirements, must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission, or the SEC, or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. As a foreign private issuer listed on the NASDAQ Global Market, we may follow home country practice with regard to, among other things, composition of our board of directors, director nomination procedure, compensation of officers, and quorum at shareholders' meetings. In addition, we may follow our home country law, instead of the NASDAQ Marketplace Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company.

ITEM 4. INFORMATION ON THE COMPANY

A. History and Development of the Company

Both our legal name and our commercial name is Formula Systems (1985) Ltd. We were incorporated in Israel on April 2, 1985. We maintain our principal executive offices at 3 Abba Eban Boulevard, Herzlia 46725, Israel and our telephone number is 011-972-9-959-8800. Our agent in the United States is Corporation Service Company and its address is 2711 Centerville Road, Suite 400, Wilmington, DE 19808. In 1991, we completed our initial public offering of ordinary shares on the Tel Aviv Stock Exchange, or the TASE. In October 1997, we completed the listing of our ADSs on the NASDAQ Global Market.

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Since our inception, we have acquired controlling interest and have invested in companies which are engaged in the IT solutions and services business. We, together with our subsidiaries and affiliates, are known as the Formula Group.

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We have adopted a strategy of seeking opportunities to realize gains through the selective sale of investments and minority interest in our subsidiaries and affiliates to outside investors. We believe that this strategy provides us with capital to support the growth of our subsidiaries, as well as increasing shareholder value. We expect to continue to develop and enhance the products, services and solutions of our subsidiaries, and to continue to pursue additional acquisitions of, or investments in, companies that provide IT services and proprietary software solutions.

Capital Expenditures and Divestitures

Certain of our investment and financing activities are described below. For additional information relating to our investment and financing activities during 2006 and 2007, see Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources.

Sale of AAOD. On December 30, 2007, our subsidiary Magic sold its wholly-owned subsidiary, Advanced Answers on Demand Holding Corporation, or AAOD, a Florida corporation that develops and markets application software targeted at the long-term care industry to Fortissimo Capital for \$17 million. Fortissimo paid to Magic \$1 million of the sale price in December 2007 and the remaining \$16 million in the beginning of 2008. In addition, as part of the transaction, Magic entered into a three-year license agreement with AAOD according to which AAOD will continue to sell Magic's products, as an OEM partner, in consideration for \$3 million, to be paid quarterly over the three years starting in 2008.

Debenture Offering by Matrix. On August 19, 2007, our subsidiary, Matrix IT Ltd., or Matrix, completed an offering of debentures in an aggregate principal amount of approximately \$62 million (NIS 250 million). The debentures were sold to institutional and other investors in Israel. The debentures bear an interest at an annual rate of 5.15%. The principal will be paid in four equal installments on December 31 of each of the years 2010 through 2013. The principal and interest are linked to the Israeli consumer price index. On February 21, 2008, Matrix listed the debentures for trading on the TASE.

Sale of BluePhoenix shares. On June 20, 2007 we completed the sale of an aggregate of 8,038,526 shares of our subsidiary BluePhoenix Solutions Ltd., or BluePhoenix, constituting our entire holdings in BluePhoenix, to international institutional investors for aggregate consideration of approximately \$64 million.

Private Placement by Sapiens. In June 2007, our subsidiary, Sapiens International Corporation N.V., or Sapiens, entered into a private placement investment transaction with several institutional investors, private investors and Formula for an aggregate gross investment amount of \$20 million (excluding finders' fees and out of pocket expenses), \$6.5 million of which was by Formula. Sapiens issued to the investors an aggregate of 6,666,667 common shares (of which 2,166,666 common shares were issued to Formula), at a price per share of \$3.00 which reflected a premium of approximately 25% above the trading price of Sapiens' common shares (as of the date Sapiens' board of directors approved the investment). The investors were all non-US persons, and the common shares were issued to the investors pursuant to Regulation S. As a result, the issuance of the common shares to the investors was exempt from registration under the Securities Act of 1933, as amended, referred to as the Securities Act.

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Spin-Off of Formula Vision. On December 26, 2006, we distributed to our shareholders a dividend consisting of 36,696,000 shares of Formula Vision, held by us and representing approximately 57% of the outstanding share capital of Formula Vision. Formula Vision shares were distributed at a ratio of 2.78 shares of Formula Vision for every one outstanding ordinary share of Formula, prior to withholding taxes. As a result, we no longer hold an interest in Formula Vision. For more information, see Item 5. Operating and Financial Review and Prospects Critical Accounting Policies Spin-off of the Investment in Formula Vision Discontinued Operation.

Repayment of Formula Vision Debt. On December 31, 2006, Formula Vision paid approximately \$51 million to us, as a full repayment of the principal of the debentures issued by Formula Vision to Formula in 2001 and 2002, including interest accrued thereon. In January 2004, Formula exchanged approximately \$35 million of the aggregate amount of the debentures for 38,000,000 shares of Formula Vision issued to Formula and constituting 59.4% of the outstanding share capital of Formula Vision at that time. In December 2005, the general meeting of shareholders approved an amendment to the debentures, pursuant to which the repayments due in 2005 and 2006 would be deferred to December 31, 2006, provided, however that the amount of cash and cash equivalents that Formula Vision holds does not exceed the amount of its bank loans (including the amount of guarantees made by Formula Vision to banks in relation to loans granted to its subsidiaries). For more information, see Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources Related Party Transactions Transactions between Us and Formula Vision.

Private Placement to FIMGold. In March 2005, we completed a private placement of 2,400,000 Formula shares for a net aggregate consideration of \$33.0 million. The shares were issued to FIMGold LP, an entity owned in equal shares by Dan Goldstein and FIMI Opportunity Fund. Concurrently with the closing of the private placement, Dan Goldstein sold to FIMGold LP all of his holdings in Formula and in Formula Vision. Following these transactions, FIMGold LP held a 33.3% controlling interest in Formula and approximately 24% interest in Formula

Vision.

Repayment of the Debenture to FIMI and IDB. In December 2005 and April 2006, we repaid to First Israel Mezzanine Investors Ltd., or FIMI, and Israel Discount Bank, or IDB, a debenture in the aggregate principal amount of \$4.7 million issued by Formula in 2002.

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B. Business Overview

General

We are a global IT solutions and services company based in Israel. We are principally engaged in providing software consulting services, developing proprietary software products and providing computer-based business solutions. We deliver our solutions in over 50 countries worldwide to customers with complex IT services needs, including a number of Fortune 1000 companies. We operate in two principal business areas, IT services and proprietary software solutions. Following is a description of our business areas:

IT Services

We design and implement IT solutions which improve the productivity of our customers' existing IT assets. In delivering our IT services, we at times use proprietary software developed by members of the Formula Group. We provide our IT services across the full system development life cycle, including definition of business requirements, system analysis, technical specifications, coding, testing, training, implementation and maintenance. We perform our projects on-site or at our own facilities.

Proprietary Software Solutions

We design, develop and market proprietary software solutions for sale in selected niche markets worldwide. We regularly seek opportunities to invest in or acquire companies with attractive proprietary software solutions under development which we believe to have market potential. The majority of our investments and acquisitions in this area have been in companies with products beyond the prototype stage. In addition, we selectively invest in companies with proven technology where we believe we can leverage our experience to enhance product positioning and increase market penetration. We provide our management and technical expertise, marketing experience and financial resources to help bring these products to market. We also assist the members of our group to form teaming agreements with strategic partners to develop a presence in international markets.

The Formula Group

Formula is the parent company of subsidiaries and affiliates, referred to collectively as the Formula Group. We currently hold a controlling interest in our subsidiaries through our equity holdings. From time to time, if and when required, we enter into voting agreements with other shareholders of the companies, in order to retain control of our subsidiaries. At present, we have no voting agreements in effect. We appoint a majority of the boards of directors of our subsidiaries through our equity holdings and, if required, through voting agreements with shareholders who are often members of our management or of our subsidiaries' management. We provide our subsidiaries with our management, technical expertise and marketing experience to help them to penetrate their respective markets.

We direct the overall strategy of our subsidiaries. While the subsidiaries each have independent management, we monitor the growth of our subsidiaries through the active involvement in the following matters:

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strategic planning;

marketing policies;

senior management recruitment;

investment and budget policy;

financing policies; and

overall ongoing monitoring of each subsidiary's performance.

We promote the synergy and cooperation among our subsidiaries by encouraging the following:

transfer of technology and expertise;

leveling of human resources demand;

combining skills for specific projects;

formation of critical mass for large projects; and

marketing and selling the group's products and services to the group's customer base.

We, through our subsidiaries, offer a wide range of integrated IT solutions and services, and design, develop and market proprietary software solutions for sale in selected niche markets, both in Israel and worldwide.

Our Subsidiaries

Matrix

Matrix IT Ltd. is one of Israel's leading integration and information technology services companies, based on Dun's 100 Israel Largest Enterprises 2007. Matrix employs over 3,500 software, hardware, integration and training personnel, which provide advanced IT services to more than 500 customers in the Israeli market. Matrix also markets in Israel software and hardware products manufactured by a broad range of international manufacturers.

The solutions, services and products supplied by Matrix are designed to improve Matrix's customers' competitive capabilities, by providing a response to their unique IT needs in all levels of their operation.

Areas of Operation

Matrix is active in four principal areas: software solutions and services, software products, infrastructure solutions and hardware products, and training and assimilation.

Software solutions and services. Matrix provides software services, software development projects, outsourcing, integration of software systems and services—all in accordance with its customers' specific needs. Matrix also provides upgrading and expansion of existing software systems. Matrix software solutions and services include the following components: (i) development of dedicated customer software systems; (ii) customization of software developed by Matrix or by third parties to provide a response to customers' requirements; (iii) systems assimilation; and (iv) integration of all or part of these components. The scope of work invested in each individual component varies from one customer to the other, based on each customer's specific requirements.

Software Products. Matrix's operations in this area include marketing and support of software products in various categories, mainly customer relationship management, referred to as CRM, software products, systems management and business service management products, software products for content management, software products for business intelligence (BI), data warehouses and extract/transform/load (ETL), software products for integration, database systems, open-code operating systems, software products for knowledge management, and software development and testing tools.

Infrastructure solutions and hardware products. Matrix's operations in this area include: (i) supply of infrastructure solutions for computer and communication systems; (ii) sale and marketing of PCs, laptops, Intel servers, peripheral equipment, operating systems, servers and

workstations operating on Unix and Linux operating systems, and sales and marketing of storage and backup systems for mainframe computers such as HP and IBM; and (iii) maintenance for computers and peripheral equipment, lab services and a help desk.

Training and assimilation. Matrix operates technological training and qualification centers providing advanced professional courses for hi-tech personnel, training and assimilation of computer systems, applications courses, professional training and training for capital market operations.

Matrix provides solutions, services and products primarily to the following four market sectors (or verticals): banking and finance, telecommunications, commerce and manufacturing, and the public and security forces sector.

Matrix offers to each market sector a broad range of solutions and services, customized for the specific needs of that sector. Matrix operates dedicated departments, each of which specializes in a particular sector. Each such department supplies customers in that sector with a product basket providing a response to most of its IT requirements, based on an in-depth business understanding of the challenges which are typical to that sector. Matrix established separate headquarters for each particular market sector, which manages the operations relating to that sector.

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Specialization in the various sectors is reflected in the applications, professional and marketing aspects of each sector. Accordingly, the professional and marketing infrastructure required to support each market sector is developed to address such sector's specific needs.

In addition to the four sector-based areas of operations, Matrix operates two horizontal divisions providing specialist services for all of the different sectors of operations. These entities include:

A technology center providing development services, which include mainly cross-sector applications and technology expertise (applications and technology expertise which can be used in more than one business sector), as well as the development of applications that require specialist resources and professional know-how; and

A strategic consulting center that provides customers with diverse consultation services on topics such as organization, strategy, business development and technological development.

Customers

Matrix's customers include large enterprises in Israel, including commercial banks (such as Bank Leumi, Bank Hapoalim, The First International Bank, Discount Bank, United Mizrahi Bank and Igud Bank), loan and mortgage banks (such as Leumi Mortgage Bank), telecommunications services providers (Bezeq, Bezeq International and Barak), cellular operators (Cellcom, Orange and Pelephone), credit card companies (Visa Cal, Isracard and Leumicard), leasing companies, insurance companies (such as Harel Hamishmar, Phoenix, Clal, Migdal), security agencies, satellite operators (YES), hi-tech companies (such as Comverse, Motorola and Amdocs), the Israeli Defense Force and government ministries and public agencies such as Israel Electric Company, Social Security, Mekorot, and media and publishing entities.

Magic

Magic Software Enterprises Ltd., or Magic, develops, markets and supports composite application development and deployment platforms with a service-oriented architecture, or SOA, including application integration and business process management, or BPM, with existing and legacy systems. Magic's products and services are available through a global network of subsidiaries, distributors and software solution providers in approximately 50 countries. Users of Magic's solutions and technology include a broad community of independent software vendors, system integrators, value added resellers and distributors, OEM partners and corporations worldwide, supported by an extensive global services organization. In addition to technology, Magic provides its customers with maintenance and technical services, as well as professional services and training.

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Magic Core Technology

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Magic embeds at its core a metadata driven rule based technology, abstracting repetitive and mundane programming chores, and enabling a high degree of agility and flexibility for solutions implemented with Magic's products.

Magic's technology solutions include a comprehensive set of resources and services, offering compliance with leading architectures and environments. Magic's products provide platform independence and interoperability.

With over 20 years of experience and thousands of customers and partners, Magic offers leading composite applications development and deployment tool suites. Using Magic's technology, customers can implement and migrate to a service-oriented architecture, leveraging existing IT assets within new business processes and composite applications, and maximize the return on past and new IT investments.

Magic delivers the following two complementary products that address the wide spectrum of SOA and composite applications:

iBOLT Business Integration Suite a flow-oriented composite applications toolset, delivering a comprehensive, business-driven integration framework that empowers enterprises to improve business performance. iBOLT enables customers to easily design, develop and deploy automated business processes, including BPM and business activity monitoring. Increasing the usability and life span of existing legacy and other business applications and IT systems, iBOLT allows fast application integration (EAI), development and customization of diverse applications, systems and databases, assuring rapid return on investment and time-to-market, increased profitability, and customer satisfaction.

eDeveloper an interactive composite application platform, delivering a productive, state-of-the-art technology for developing and deploying Web and client/server applications across and beyond the enterprise. eDeveloper automates the mundane repetitive tasks of the software development cycle significantly shortening the process; reducing project risk; and minimizing human errors.

Magic development and integration products empower customers to significantly improve their business performance and return on investments by enabling the affordable and rapid integration of diverse applications, systems and databases to streamline business processes.

Magic's technologies adhere to open standards and deliver high levels of portability and scalability, crucial for today's dynamic business environment, and operate as a uniform application paradigm independent of architecture (Internet, client/server, mobile, LAN/WAN), operating systems (Windows, Linux, UNIX, iSeries), database (DB2, Oracle, Informix, MS SQLServer, Pervasive and others), or platform (.NET, J2EE).

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Enabling Business

Magic technology and solutions are particularly in demand when time-to-market is critical, budgets are tight, integration with multiple platforms, databases or existing systems and business processes is required, compliance to industry regulations is needed or a high degree of application maintenance and customization is anticipated.

Magic addresses customers' critical business need to respond quickly to changing market demands. Magic's robust business solutions are created, deployed and maintained with unrivaled productivity and time-to-market results. Magic's combination of event driven and service-oriented architecture enables developers to master the tools and create better solutions within a shorter time and with fewer resources.

Development communities have become increasingly disjointed, creating an even greater need for a development environment that provides open interfaces to leading technologies and standards. Magic's eDeveloper and iBOLT products provide developers, system architects and IT persons with the ability to rapidly build integrated applications in a more productive manner, lowering IT maintenance costs and decreasing time-to-market.

A wide variety of developers use Magic's products, including in-house corporate development teams and software houses. Large and medium sized system integrators use Magic's products in large customized system integration projects and for developing industry-specific vertical applications.

Professional Services

Magic, together with Magic's partners, offers customers application integration and development services that assist customers in maximizing their development investments. These services include project management, technical support, installation services, application development, integration, consulting and training. All projects are subject to a rigorous standard for project management and quality assurance. Nevertheless, Magic's goal is to provide such activities as a complementary service to customers and partners as part of its focus on license sales.

Strategic Alliances

Magic forms strategic alliances to help deliver complete solutions to customers. These solutions encompass application integration, development, vertical domain expertise and hardware implementation. Magic maintains strategic alliances with leading vendors, like SAP, IBM, Oracle, Salesforce.com and Iway. Magic's partnership with SAP, entered into in 2004, focuses on providing a special edition of iBOLT which extends the value of SAP implementations with capabilities such as extended workflows, composite applications, multi-channel access, interoperability and integration with other systems and platforms, as well as business activity and performance monitoring. Magic applies the same marketing concept to other leading enterprise application ecosystems, with special editions of iBOLT for Oracle's JD Edwards and Salesforce.com CRM. In addition, Magic has alliances with system integrators, software and hardware vendors and consulting organizations. These partnerships enable Magic to better serve its customers worldwide.

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Vertical Solutions

Magic also develops, markets, and supports, through its subsidiaries and affiliates, vertical applications, including long-term care, cargo handling and inventory control solutions.

Cargo handling Hermes (formerly Magic eCargo) is a comprehensive solution for cargo handling and inventory control that is designed to increase productivity, improve efficiency, and reduce costs. Hermes handles many aspects of a cargo operation including inventory control, automated build-up of flights/manifesting, messaging to CARGO-IMP standards, customs clearance, weight and balance departure control systems, interfacing, scanning and verification of cargo, secured tracking and a comprehensive financial package for all aspects of charging, collecting fees and invoicing.

Banking Nextstep Infotech PVT Ltd. develops and markets Cheq Mate, a banking application that provides most of the functionality needed to run a retail branch, including support for various deposit types, advances, time deposits, bank guarantees, letters of credit and portfolio management.

Professional Services CoreTech is an information technology consulting firm offering flexible and creative solutions in the areas of infrastructure design and delivery, application development, technology planning and implementation services, and supplemental staffing.

Markets and Customers

Magic markets and sells its products and services in approximately 50 countries worldwide. Industries that are significantly represented in the Magic community base include finance, retail, media, telecommunications, manufacturing, healthcare and government agencies. Among the thousands of end-users running their business systems with Magic's technology, are the following:

Adidas-Solomon	Financial Times	Minolta
Allstate	GAP	NEC
Athlon Group	Hitachi	Nestle Nespresso
Bank of France	John Menzies	Nintendo
Burger King	Kodak	Philip Morris
Chase Manhattan Bank	Marconi Mobile	State of Washington
Club Med	Matsushita	The United Nations
Compass Group PLC	McDonalds	Victorinox
Deka Bank	McKesson HBOC	Vodafone
Fiat	Merrill Lynch	

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Sapiens

Sapiens International Corporation N.V. is a global provider of IT solutions that modernize business processes to enable insurance and other leading companies to quickly adapt to changes. Sapiens' solutions, sold as customizable software modules, align IT with business demands for speed, flexibility and efficiency. Sapiens' solutions are supplemented by its technology, methodology and consulting services, which address the

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complex issues related to the life-cycle of enterprise business applications. Sapiens solutions include scalable insurance applications developed for leading organizations such as AXA, Norwich Union, Liverpool Victoria, IAT Group, ING, OneBeacon, Principal Financial Group, Texas Farm Bureau Insurance Companies, Menora Mivtachim Insurance and Santam. Sapiens service offerings include a standard consulting offering that helps customers make better use of IT in order to achieve their business objectives.

Sapiens core technology, *Sapiens eMerge*, is a rules-based application development suite which enables rapid solution development for complex mission-critical enterprises to deliver new functionality, achieve legacy modernization and enterprise application integration. The primary building block of Sapiens solution offerings is Sapiens eMerge, Sapiens business rules engine. The use of Sapiens eMerge reduces the complexity of programming so that new applications and modifications of existing ones can be produced in a much shorter time than through conventional programming.

Another key advantage of Sapiens eMerge is the ability to extend the productive life of older computer systems, while at the same time providing the basis for using new generation Internet and service-oriented technologies. The use of rapid application development allows enterprise-specific enhancements to be made in a shorter time and with a greatly reduced maintenance burden when compared to other technologies.

Development, deployment, integration and administration of applications are all accomplished through the technology components of Sapiens eMerge, providing customers with flexible, scalable and feature-rich systems. Sapiens eMerge, which serves over 100 of Sapiens customers worldwide, reduces the cost of business software development and maintenance.

Sapiens markets its solutions globally through its direct sales force and through marketing alliances with global IT providers, such as IBM Corporation and Electronic Data Systems Corporation. Sapiens is a Premier Business Partner of IBM and works with IBM on solutions, joint development, testing, validation and marketing. Through this and other business alliances, Sapiens has developed extensive knowledge in mainframe and mid-range systems, including CICS, DB2, MQ and the WebSphere e-business platform. Sapiens is also a member of IBM's Insurance Application Architecture (IAA) group and the ISV Advantage Program for the small and medium business insurance market segment.

Sapiens Business Solutions for the Insurance Industry

Sapiens has formulated Sapiens INSIGHT, a suite of modular business software solutions that make use of existing assets to quickly and cost-effectively modernize business processes that are the key to survival in the current, challenging insurance landscape. Sapiens insurance solutions, which include the Sapiens INSIGHT family, are based on Sapiens core technology, Sapiens eMerge.

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Sapiens INSIGHT is designed for the general (property and casualty) and life insurance markets. These solutions can be customized to match specific legacy systems and business requirements, while providing pre-configured functionality. These solutions can be used independently or together as follows:

SapiensINSIGHT for Property & Casualty is a fully functional, general insurance policy administration solution that makes it easier for brokers and agents to do business with carriers. By automating the process, this web-enabled solution reduces the cost of doing business and optimizes risk selection through the use of rules based underwriting.

SapiensINSIGHT for Life & Pensions is a powerful and comprehensive framework-based life and pensions solution that serves companies administering life insurance, pension funds, health insurance and saving plans. Sapiens INSIGHT for Life & Pensions is dynamic, highly customizable and can be easily accommodated to administer changes in processes. It is fully web-enabled, prepared to utilize the advantages of the internet and intranet.

SapiensINSIGHT for Underwriting (formerly MediRisk INSIGHT) is an underwriting solution for life, health and disability insurance. It reduces customer's costs by automating a larger portion of the process of evaluating the risks of new business and by streamlining the procedures for handling new business. By using this solution, an insurance company can make underwriting assessments on new cases earlier in the business cycle and achieve greater consistency in its decision-making. Sapiens markets INSIGHT for Underwriting on the basis of licensing and distribution agreements with MediRisk Solutions Ltd. which developed the solution and holds the intellectual property rights to it.

SapiensINSIGHT for Reinsurance is a functional-rich solution for the insurance market, designed to support insurance carriers in the management of all types of reinsurance for the general (property and casualty) and life insurance markets, according to the rapidly changing requirements of the international reinsurance market. This state-of-the-art, web-enabled solution streamlines and reduces the cost of handling all reinsurance functions through automation, is based on ACORD standards and B2B XML

technology, and is designed for a multi-language, multi-currency and multi-company environment.

SapiensINSIGHT for Closed Books, also known as LifeLite, is a solution for life insurance companies and pension funds seeking ways to reduce the cost of maintaining long-term closed books of business, that is, lines of business that are no longer current. Sapiens provides customizable solutions that enable companies to efficiently and more effectively administer policies and claims relating to closed books.

Sapiens collaborates with its customers to tailor the Sapiens INSIGHT solutions to achieve the unique operational performance goals of each organization. In addition, Sapiens has executed independent projects for the insurance market, providing enhanced information access and visibility to empower the sales, agent and broker community, thus accelerating transaction processing for improved customer service and business efficiency. Sapiens insurance solutions are compatible with a variety of platforms including IBM zSeries and iSeries, HP UNIX at the host-side and Windows 2000/XP Web servers. They are also compatible with open architecture standards such as .NET, Java EE, XML, Web Services and application server platforms such as IBM's WebSphere .

Services

Outsourcing of application maintenance. Sapiens outsourcing services were developed from its strong, long-term relationships with its customers. Sapiens is currently servicing multi-year outsourcing contracts with blue-chip customers involving mission-critical systems. The outsourcing projects are performed either on or off the customers premises. Sapiens asset discovery solution contributes to the maintenance and management of an enterprise's IT environment.

IT Services. Sapiens provides customers with specialized IT services in many areas, including project management and technical assistance. Sapiens personnel work with the customer for the duration of the entire project, collectively undertaking design, development and deployment tasks, coupled with hands-on-training, to achieve a rapid software solution that matches the customer's business and IT goals.

Customers

Sapiens INISGHT . Sapiens markets the Sapiens INISGHT suite of solutions to insurance carriers in four main categories: Property & Casualty (known as General Insurance in Europe); Life and Pensions (known as Life and Health in the US), Reinsurance and Medical Underwriting. Sapiens customers and target markets have direct written premiums in the range of \$80 million to \$5 billion per year. However, given the flexibility and modularity of the Sapiens INISGHT suite of solutions, its offerings can accommodate most situations and budgets.

Sapiens eMerge . Sapiens markets Sapiens eMerge primarily to corporate customers and government entities with large information technology budgets and ongoing maintenance and development needs. Sapiens corporate customers include, among others, insurance companies, banks and other companies offering financial services and companies in the manufacturing and transportation sectors. The principal markets in which Sapiens competes are located in North America, Europe, Israel and Japan.

nextSource Inc.

nextSource operates in the field of workforce solutions by developing and delivering an innovative and comprehensive suite of services and products. This model allows customers to engage nextSource for one or any combination of solutions that address the rapidly changing challenges posed to the customer by today's global, complex workforce. nextSource ability to meet a customer's entire workforce management present and future needs, as a single source, positions it as the workforce solutions provider of choice.

nextSource's wheel of integrated solutions include:

Vendor Management Talent Acquisition Management Solution (TAMS)

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One of nextSource's key products is its intuitive, web-based vendor management system named Talent Acquisition Management Solution, or TAMS. TAMS is a scalable, 8th generation vendor management software application. TAMS automates the process of acquiring and managing a customer's workforce consisting of temporary staffing, contract workers, consultants and direct hires. TAMS also facilitates the competitive sourcing and tracking of fixed price, deliverable-based projects.

TAMS introduces process improvements resulting in the elimination of inefficiencies, reducing the amount of time HR managers and procurement teams spend in acquiring and tracking contingent workforces. The application provides timekeeping, invoicing, online requisitioning, online purchase orders and all approvals associated with each function. nextSource is able to configure the application to fit its customers' specifications with minimal implementation time through nextSource's highly experienced implementation team.

Salary & Rate Benchmarking - The PeopleTicker

nextSource's key product in this area, The People Ticker, is the industry's only web-based, real-time rate and salary benchmarking tool for full-time and contingent compensation. The People Ticker replaces the antiquated salary survey approach by providing users with real time rate and salary data specific to an industry, geographic region and job description. With this powerful application, customers are able to assess and react to the cost of specific labor market fluctuations on a real-time basis. The application takes the guesswork out of establishing geography and position specific, hourly rates and full-time salaries for employees based on current market supply and demand. Armed with this information, customers are now able to hire and retain employees, procure contingent labor and budget for project-based initiatives in a cost effective manner. Currently, The PeopleTicker is in its 3rd generation and covers the United States, Canada, United Kingdom and India.

Payrolling Services/Third-Party Employer of Record Services

nextSource offers a comprehensive payrolling and risk mitigation service. nextSource payrolling services protect its customers and mitigate risks and the many legal issues surrounding the acquisition of 1099s or independent contractors. nextSource serves as the employer of record for these resources providing customers with the ability to maintain flexible workforce capabilities. nextSource complements its payrolling services offering with People Time, a web-based, time and attendance tracking application enabling hiring managers to collect and report worker time and cost data.

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Staffing

Through ConsultingDirect, nextSource creates an efficient web-enabled labor market/reverse auction through which a pool of pre-screened and pre-qualified members of its Registry of Certified Consultants (ROCC), have the opportunity to bid for open positions. ROCC members provide their requested hourly rate or project fee and the customer is able to make an informed decision in a highly competitive, transparent auction-type market for each job posting. nextSource believes that this system provides a very efficient process for customers to reach a wide group of pre-screened, pre-negotiated candidates.

Agency Exchange

In 2003, nextSource created The Multiple Listing Staffing Association (MLSA), an industry-wide network of independent, nextSource-qualified staffing agencies. The MLSA brings together staffing agencies working cooperatively with one another under the nextSource umbrella. Members of the MLSA can post an unlimited number of openings of any type on nextSource's web-based portal and increase their own qualified candidate pool by accessing the nextSource database of candidates, in addition to accessing new customers and additional openings from other agencies.

HR/Procurement Consulting

nextSource provides HR and procurement consulting, including assisting customers with the negotiation of rates and supplier agreements and the establishment of agency performance metrics. nextSource also offers salary and compensation analysis, assessment of co-employment risks, review of on-boarding and off-boarding procedures and other HR policies and processes.

Sales and Marketing

Our subsidiaries conduct sales and marketing efforts primarily through division or product managers. In certain cases, the companies devote sales managers who, aided by their staffs, are responsible for ongoing customer relationships, as well as sales to new customers. In addition, the IT services companies participate in competitive bidding processes, primarily for turnkey and government projects, as well as large IT services contracts. Our subsidiaries attend trade shows and exhibitions in the high technology markets, while further supplementing their sales efforts with space advertising and products and services listing in appropriate directories. In addition, our subsidiaries organize user group meetings for their customers, where new products and services are highlighted. We typically enter into strategic alliances and intend to pursue acquisitions in order to penetrate various international markets and promote sales of our proprietary software solutions in international markets.

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The following table summarizes our revenues by operating segments for the periods indicated:

	Software Services	Proprietary Software Products	Total
	\$ in thousands		
<u>Year ended December 31,</u>			
2007	392,527	100,823	493,350
2006	319,939	96,868	416,807
2005	274,901	90,940	365,841

The following table summarizes the revenues from our IT products and services by geographic regions of our customers, for the periods indicated:

	Year ended December 31,		
	2007	2006	2005
	\$ in thousands		
Israel	319,444	264,293	228,812
International:			
United States	120,051	93,479	74,126
Other	53,855	59,035	62,903
	173,906	152,514	137,029
Total	493,350	416,807	365,841

Competition

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The markets for the IT products and services we offer are rapidly evolving and highly competitive. Our ability to compete successfully in IT services markets depends on a number of factors, like breadth of service offerings, sales and marketing efforts, service, pricing, and quality and reliability of services. The principal competitive factors affecting the market for the proprietary software solutions include product performance and reliability, product functionality, availability of experienced personnel, price, ability to respond in a timely manner to changing customer needs, ease of use, training and quality of support.

We face competition, both in Israel and internationally, from a variety of companies, including companies with significantly greater resources than us who are likely to enjoy substantial competitive advantages, including:

longer operating histories;

greater financial, technical, marketing and other resources;

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greater name recognition;

well-established relationships with our current and potential clients; and

a broader range of products and services.

As a result, they may be able to respond more quickly to new or emerging technologies or changes in customer requirements. They may also benefit from greater purchasing economies, offer more aggressive product and service pricing or devote greater resources to the promotion of their products and services. In addition, in the future, we may face further competition from new market entrants and possible alliances between existing competitors. We also face additional competition as we continue to penetrate international markets. As a result, we cannot assure you that the products and solutions we offer will compete successfully with those of our competitors. Furthermore, several software development centers worldwide offer software development services at much lower prices than we do. Due to the intense competition in the markets in which we operate, software products prices may fluctuate significantly. As a result, we may have to reduce the prices of our products.

Matrix's principal competitors in the domestic Israeli market are Israeli IT services companies and systems integrators, the largest of which are Ness Technologies Inc. and Team-Malam. Matrix's international competitors in the Israeli marketplace include HP, EDS, IBM and Microsoft. These international competitors often use local subcontractors to provide personnel for contracts performed in Israel. Most of these international entities are also business partners of Matrix.

Magic's principal competitors in the market for the eDeveloper technology are Visual Basic (Microsoft), Progress, Delphi and Jbuilder (Borland), Java, Oracle, Compuware and Lansa. The principal competitors in the market for Magic's iBOLT Integration Suite are Software AG, Tibco, Vitria, Pegasystems, Cordys, IBM's WebSphere, Microsoft's BizTalk and Sonic Software (Progress).

Sapiens' competitors in the market for solutions offered to the insurance industry fall into several categories: vendors of complete systems, vendors of insurance software products, large multinational integrators and local integrators in the various territories where Sapiens operates.

Examples of Sapiens' competitors are: CSC, Camilion, SOLCORP, Fineos, SAP, SunGard, Navisys, Fiserv, OneShield, Ascendant One, Insurity, IDP, The Innovation Group, Duck Creek and AQS in the United States; Unisys, SunGard, FIS Software and RebusIs in the United Kingdom; Falmeyer (FJA), COR AG Insurance Technologies and IDIT IDI Technologies in Europe. Examples of large integrators in the insurance field are Electronic Data Systems and CSC (companies that also have customer or alliance relationships with Sapiens in other fields). An example of a competitor that is a local integrator is Ness Technologies in Israel.

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In addition, Sapiens faces competition from its customers' and potential customers' internal IT departments, who often prefer to develop solutions in-house.

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Sapiens competitors in the business rule engines and management marketplace include Fair Isaac (Blaze), Pegasystems, ILOG, Computer Associates, Haley, Corticon, Versata, RuleBurst and ESI.

Software Development

The software industry is characterized by rapid technological developments. In order to maintain technological leadership, we engage in ongoing software development activity through our subsidiaries, aimed at both creating new proprietary software and services, as well as enhancing and customizing existing products and services. This effort includes introducing new supported programming languages and database management systems; improving functionality and flexibility and enhancing ease of use. We work closely with current and potential end-users, our strategic partners and leaders in certain industry segments to identify market needs and define appropriate product enhancements and specifications.

Intellectual Property Rights

We rely on a combination of trade secret, copyright and trademark laws and non-disclosure agreements, to protect our proprietary know-how. Some members of our group have patents and patent applications pending. Our proprietary technology incorporates processes, methods, algorithms and software that we believe are not easily copied. Despite these precautions, it may be possible for unauthorized third parties to copy aspects of our products or to obtain and use information that we regard as proprietary. We believe that, because of the rapid pace of technological change in the industry, patent and copyright protection are less significant to our competitive position than factors such as the knowledge, ability and experience of our personnel, new product development and ongoing product maintenance and support.

C. Organizational Structure

Formula is the parent company of the Formula Group.

The following table presents certain information regarding the control and ownership of our significant subsidiaries, as of June 20, 2008.

<u>Subsidiary</u>	<u>Country of Incorporation</u>	<u>Percentage Of Ownership</u>
Matrix IT Ltd.	Israel	50.1%
Magic Software Enterprises Ltd.	Israel	54.6%
Sapiens International Corporation N.V.	Netherlands Antilles Islands	58.1%
nextSource Inc.	United States	100.00%

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We sold our entire shareholdings in BluePhoenix in June 2007.

The ordinary shares of Magic and Sapiens are traded on the NASDAQ Global Market and on the TASE, and the ordinary shares of Matrix are traded on the TASE.

D. Property, Plants and Equipment

Our corporate headquarters, as well as the research and development and sales and marketing headquarters of a majority of our subsidiaries, are located in Herzlia, Israel. We lease approximately 100,000 square feet of office space in Herzlia, pursuant to a lease which expires on October 31, 2009. We also lease approximately 190,000 square feet of office space in several other locations in Israel.

We own a 39,300 square feet facility in Or-Yehuda, Israel used for office space of Magic.

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In addition, Sapiens leases approximately 45,000 square feet of office space in Rechovot, Israel, 4,700 square feet in the United States and 13,800 square feet in Great Britain, Magic leases approximately 12,800 square feet of office space in the United States and several of our subsidiaries lease some additional office space and sales and support premises in the United States, Europe and Asia.

We believe that our properties are adequate for our present uses. If in the future we require additional space to accommodate our growth, we believe that we will be able to obtain this additional space without difficulty and at commercially reasonable prices.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Overview

Formula is the parent company of subsidiaries and affiliates, referred to collectively as the Formula Group. We are principally engaged in providing software consulting services, developing proprietary software products and providing computer-based business solutions. We currently hold a controlling interest in three publicly traded subsidiaries: Magic, Matrix and Sapiens. In addition, we wholly own nextSource. We consolidate the results of operations of our subsidiaries in which we hold a controlling interest, with ours. Our operating results are directly influenced by the consolidation and cessation of consolidation of our subsidiaries. This could cause significant fluctuations of our consolidated operating results. As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and you should not rely on these comparisons as indications of our future performance.

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On December 30, 2007, our subsidiary Magic sold its entire holdings in AAOD for \$17 million. For more information, see Item 4.A. Capital Expenditures and Divestitures.

On June 20, 2007 we completed the sale of our entire holdings in our subsidiary BluePhoenix to international institutional investors for aggregate consideration of approximately \$64 million. Formula recognized capital gains of approximately \$18 million from the sale.

On December 26, 2006, we spun-off Formula Vision. The spin-off was effected by way of distributing 36,696,000 Formula Vision shares owned by us (representing approximately 57% of the outstanding share capital of Formula Vision) as a dividend to our shareholders. For more information, see Critical Accounting Policies- Spin-off of the Investment in Formula Vision and Critical Accounting Policies Discontinued Operation below.

On December 31, 2006, Formula Vision paid to us approximately \$51 million, as a full repayment of the principal of the debentures and interest accrued thereon.

We recognize revenues in two categories: the delivery of software services and the delivery of proprietary software solutions. All of our subsidiaries, including IT services companies and proprietary software solutions companies, recognize revenues from the delivery of software services, and most of them recognize revenues in both revenue categories. We have separated our subsidiaries into these categories in accordance with the category in which each subsidiary has earned most of its revenues.

We recognize, in non-operating income, gains and losses arising from the sale of previously un-issued capital stock by a subsidiary or an affiliate to outside investors, if the sale changes our ownership percentage in this entity. We measure the gain or loss by the difference between our share in the proceeds from this stock offering and the carrying amount, on an equity basis, of the proportionate reduction in our investment. Transactions of this nature do not occur on a regular basis and it is difficult for us to predict their timing.

Our functional and reporting currency

Beginning in 2007, Formula changed its functional currency from NIS to the dollar since most of its assets are denominated in dollars and Formula has no outstanding NIS loans. This, according to indicators as mentioned in Financial Accounting Standards Board Statement no. 52

Foreign Currency Translation, referred to SFAS 52. Prior to 2007, Formula operated primarily in the economic environment of the New Israeli Shekel (NIS) and its functional currency was the NIS. The functional currencies of Formula's subsidiaries are the NIS and the dollar. Formula

has elected to use the dollar as its reporting currency.

Formula translates the financial statements of its subsidiaries whose functional currency is the NIS, into dollars, under the principles described in SFAS 52. Assets and liabilities have been translated at period-end exchange rates. Results of operations have been translated at the exchange rate at the dates on which those transactions occurred or at an average rate. We present differences resulting from translation under shareholders' equity in the item accumulating other comprehensive income (loss). In the consolidation, Formula presents the financial statements of subsidiaries whose functional currency is the dollar, at the original amounts.

The comparative figures for 2006 and 2005 have been measured under the assumption that Formula's functional currency was the NIS. The financial statements of prior years of Formula and most of its subsidiaries whose functional currency is the NIS have been translated into dollars under the principles described in SFAS 52.

Critical Accounting Policies

In preparation of our financial statements, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. The significant accounting policies which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue Recognition

The revenue recognition policy of each of our significant subsidiaries is material because our revenue is a key component of our results of operations. Our revenue recognition determines the timing of certain expenses, such as commissions and royalties. We follow very specific and detailed guidelines in measuring revenue; however, certain judgments affect the application of our revenue policy. Revenue results are difficult to predict and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in future operating losses. Should changes in conditions cause our subsidiaries' managements to determine that these guidelines are not met for certain future transactions, revenue recognized for any reporting period could be adversely affected.

Revenues derived from direct software license agreements are recognized in accordance with Statement of Position (SOP) 97-2 Software Revenue Recognition (as amended by SOP 98-4 and SOP 98-9), upon delivery of the software when collection is probable, the license fee is otherwise fixed or determinable and persuasive evidence of an arrangement exists. When a project involves significant modification of software, revenue is generally recognized according to the percentage of completion method. Under this method, estimated revenue is generally accrued based on costs incurred to date as a percentage of total updated estimated costs. If our subsidiaries do not accurately estimate the resources required or the scope of work to be performed, or do not manage their projects properly within the planned periods of time or satisfy their obligations under the contracts, then future margins may be significantly and negatively affected or losses on existing contracts may need to be recognized. Any such resulting reductions in margins or contract losses could be material to our results of operations. Our subsidiaries recognize contract losses, if any, in the period in which they first become evident.

SOP No. 97-2 generally requires revenue earned from software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements determined by the vendor's specific objective evidence, or VSOE, of fair value. Revenue is recognized under the residual method when VSOE of fair value exists for all undelivered elements and VSOE of fair value does not exist for all of the delivered elements, and when all SOP No. 97-2 criteria for revenue recognition are met, as described above. The VSOE of fair value of the undelivered elements included in multiple element arrangement (maintenance, support and services) is determined based on the price charged for the undelivered element when sold separately.

Generally there are no rights of return, price protection or similar contingencies in our subsidiaries' contracts. Accordingly, they do not establish a provision due to the lack of warranties' claims in the past. Some of our subsidiaries' contracts include customer acceptance clauses. In determining whether revenue can be recognized, when an acceptance clause exists, they consider their history with similar arrangements, the customer's involvement in the progress, the existence of other service providers and the payments terms.

We recognize revenues from projects billed on a time and material basis, based on SOP 81-1 Accounting for Performance of Construction Type and Certain Production Type Contracts, using contract accounting on a percentage of completion method, based on the relationship of

actual costs incurred to total costs estimated to be incurred over the duration of the contract. Provision for estimated losses on uncompleted contracts is made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract.

We recognize revenues from consulting fees with respect to fixed fee contracts, based upon the percentage of completion method. We recognize contract losses, if any, in the period in which they first become evident.

Revenues from contractual maintenance contract and training are recognized ratably over the contract period.

Revenues from sales of hardware are recognized when the merchandise is delivered to the customer, provided no significant vendor obligations remain.

Our management believes that our revenue recognition policies are in accordance with the SEC Staff Accounting Bulletin No. 101 and Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements.

Capitalized Software Research and Development Costs

Development costs of software that is intended for sale that were incurred after the establishment of technological feasibility of the relevant product, are capitalized. Technological feasibility is determined by our subsidiaries when detailed program design is completed and verified in accordance with the provisions of the FASB Statement of Financial Accounting Standards No. 86 (SFAS 86). Software development costs incurred by our subsidiaries before technological feasibility is established are charged to the statement of operations as incurred net of participation of the Office of the Chief Scientist (OCS). Our subsidiaries' policy on capitalized software costs determines the timing of our recognition of certain development costs. In addition, this policy determines whether the cost is classified as development expense or capitalized costs. Our subsidiaries' management is required to use professional judgment in determining whether development costs meet the criteria for immediate expense or capitalization. Amortization of capitalized software development costs begins when the product is available for general release to customers. Annual amortization is computed by the straight-line method, over the remaining useful life of the product, or based on the ratio of current gross revenues to current and anticipated future gross revenues, whichever is higher. Currently, amortization is computed by the straight-line method over a period of 3 to 5 years. Our subsidiaries' failure to accurately predict the useful life of capitalized software could cause a one-time amortization, which could adversely affect our operating results.

Impairment of Goodwill and Intangible Assets

Our business acquisitions resulted in goodwill and other intangible assets. We periodically evaluate our goodwill, intangible assets, and investments in affiliates for potential impairment indicators. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance of our acquired businesses and investments.

In accordance with FASB Statement of Financial Accounting Standards No. 142 Goodwill and Other intangible Assets (SFAS 142), indefinite life intangible assets and goodwill are not amortized but rather subject to annual impairment testing.

Goodwill and intangible assets are tested for impairment by comparing the fair value of the reporting unit with its carrying value. Fair value is generally determined using discounted cash flows, market multiples and market capitalization. Significant estimates used in the fair value methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples of the reportable unit. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for our goodwill and intangible assets. These write downs, if any, may have an adverse affect on our operating results. Future events could cause us to conclude that impairment indicators exist and that additional intangible assets associated with our acquired businesses are impaired.

The process of evaluating the potential impairment of goodwill is subjective and requires significant judgment at many points during the analysis. Changes in judgment on these assumptions and estimates could result in a goodwill impairment charge. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Spin-off of the Investment in Formula Vision

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According to APB No. 29 *Accounting for Nonmonetary Transactions*, a spin off is accounted as a decrease in the company's retained earnings and measured according to the book value of the investment as of the spin-off date.

Discontinued Operation

Under SFAS 144, when a component of an entity, as defined in SFAS 144, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on its disposal should be classified as discontinued operations and the assets and liabilities of such component should be classified as assets and liabilities attributed to discontinued operations. The operations, assets and liabilities of the component would be eliminated from the company's consolidated operations and the company will no longer have any significant continuing involvement in the operations of the component.

Share-Based Payments

Effective January 1, 2006, we adopted Statement of Financial Accounting Statement No. 123 (revised 2004), *Share-Based Payment*, referred to as SFAS 123(R), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, which requires the measurement and recognition of compensation expense based on estimated fair values for all shared based payments awards made to employees and directors. In March 2005, the SEC issued Staff Accounting Bulletin No. 107, or SAB 107, relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

SFAS 123(R) requires us to estimate the fair value equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the awards that is ultimately expected to vest is recognized as an expense over the requisite service periods in our consolidated statement of operations. Prior to the adoption of SFAS 123(R), we accounted for equity based awards under the fair value recognition provisions of SFAS 123.

We adopted SFAS 123(R) using the Modified Prospective Method. Under that transition method, compensation cost recognized in the year ended December 31, 2007 included: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of the SFAS 123(R). In December 2005, primarily as a result of the issuance of SFAS 123(R), we accelerated the vesting of all unvested stock options held by employees and directors.

Beginning on the date of adoption of SFAS 123(R), we estimate forfeitures based on historical experience and other factors; previously, we recorded forfeitures as they occurred.

A. Operating Results

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

Revenues. Revenues increased 18% from \$416.8 million in 2006 to \$493.4 million in 2007. Revenues from the two categories of our operation were as follows: Revenues from the delivery of software services increased 23% from \$320.0 million in 2006 to \$392.5 million in 2007. This increase was attributable to the growth in Matrix's and nextSource's revenues due to an increased demand for their services. Revenues from the sale of proprietary software solutions in 2007 were \$100.8 million compared to \$96.9 million in 2006. This increase was attributable to increase in Magic's revenues which were offset by a decrease in Sapiens's revenues.

Cost of Revenues. Cost of revenues consists primarily of wages and related expenses and hardware and other materials costs. Cost of revenues increased 19% from \$309.4 million in 2006 to \$369.1 million in 2007. As a percentage of revenues, cost of revenues were relatively at the same level in 2006 and in 2007, 74% and 75%, respectively. Our software services sales are generally characterized by a lower gross margin than sales of proprietary software solutions. Cost of revenues for proprietary software solutions were \$52.9 million in 2007 and \$53.8 million in 2006. Cost of revenues for software services increased 24% from \$255.6 million in 2006 to \$316.1 million in 2007, primarily due to the increase in the cost of revenues of our subsidiaries Matrix and nextSource.

Software Development Costs, net. Software development costs consist primarily of wages and related expenses and, to a lesser degree, consulting fees we pay to independent contractors engaged in research and development. Software development costs, net, consist of software development costs, gross, less capitalized software costs. Software development costs, gross, in 2007 and 2006 were \$12.6 million and \$14.0

million, respectively. In 2007, we capitalized software costs of \$6.2 million compared to \$8.5 million in 2006. Capitalization of software costs in 2007 was attributable to our proprietary software solutions subsidiaries. Software development costs, net, increased from \$5.5 million in 2006 to \$6.5 million in 2007. As a percentage of revenues, software development costs, net remained at the same level of 1.3% in 2006 and 2007. The increase in software development costs was attributable primarily to Magic and Sapiens which had research and development expenditures of approximately \$2.7 million and \$3.5 million, respectively. Amortization of capitalized software costs was \$6.4 million in 2007 and \$8.9 million in 2006, which amounts were included in cost of revenues.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of salaries, severance and related expenses, travel expenses, selling expenses, rent, utilities, depreciation, amortization and professional fees. Selling, general and administrative expenses in 2007 and 2006 were \$90.5 million and \$88.8 million, respectively. As a percentage of revenues, selling, general and administrative expenses were 18.3% in 2007 and 21.3% in 2006. The increase in selling, general and administrative expenses was primarily attributable to an increase in selling, general and administrative expenses of Matrix which was offset by a decrease in selling, general and administrative expenses of Sapiens and Magic.

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Restructuring Costs. We had no restructuring costs in 2007. Restructuring costs in 2006 were \$2.9 million and were primarily attributable to restructuring activities of Magic, which had restructuring costs of \$2.1 million, and Sapiens which had restructuring costs of \$758,000. The restructuring costs of Magic resulted mainly from severance payments paid in connection with the restructuring and impairment plan announced by Magic in the third quarter of 2006, which aimed to reduce costs and improve profitability.

Operating Income. Our operating income increased from \$10.1 million in 2006 to \$27.2 million in 2007. The operating income in 2007 was attributable to the improvement in the operating results of all of our subsidiaries, and in particular Matrix which had operating income of \$24.5 million, Magic which had operating income of \$1.3 million and Sapiens which had operating income \$800,000. The operating income in 2006 was attributable to the improvement in the operating results of our subsidiaries, and in particular Matrix which had operating income of \$19.2 million and a decrease in the net operating loss of Sapiens, which had operating loss of \$1.3 million. This improvement was offset by the operating loss of \$6.7 million of Magic.

Financial Expenses, net. Financial expenses, net decreased from \$4.6 million in 2006 to \$3.8 million in 2007. Financial expenses, net, is influenced by various factors, including our cash balances, loan balances, changes in the exchange rate of the NIS against the dollar, changes in the exchange rate of the dollar against the euro and changes in the Israeli CPI. Financial expenses, net in 2007 are attributable to interest expenses incurred by our subsidiaries, Matrix and Sapiens, which had financial expenses of \$2.1 million and \$2.8 million, respectively, resulting from issuance of debentures. These expenses were offset by financial income in Formula which resulted from interest derived from short-term deposits and exchange rate differentials.

Other income (expenses), net. Other expenses, net in 2007 and 2006 were \$750,000 and \$1.1 million, respectively.

Gain on Realization of Shareholdings. Gain on realization of shareholdings in 2007 was \$2.0 million compared to \$3.7 million in 2006. Gain on realization of shareholdings in 2007 was primarily attributable to a gain from a decrease in our shareholding in Sapiens due to a private placement consummated by Sapiens. Gain on realization of shareholdings in 2006 was attributable primarily to the sale by Matrix of its holdings in Matrix-1 One Ltd. and the decrease in the percentage of shareholdings by Matrix of its subsidiary, Tiltan, which resulted in aggregate consideration of approximately \$4.0 million.

Taxes on Income. Taxes on income in 2007 were \$1.9 million compared to \$3.8 million in 2006. The decrease in taxes on income in 2007 was mainly attributable to the decrease in taxes of Matrix.

Company's Equity in Results of Affiliates, net. Our equity in losses of affiliates, net were \$653,000 in 2007 compared to a gain of \$47,000 in 2006. Equity in losses of affiliates in 2006 was attributable primarily to equity in losses of affiliates of Matrix.

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Minority Interest, net. Minority interest, net, includes the minority interest in companies which are not wholly owned by the Formula Group during each of the periods indicated. Minority interest in profits of subsidiaries in 2007 was \$9.7 million compared to \$4.8 million in 2006. This increase was primarily attributable to the improvement in the results of all of our subsidiaries, and, in particular, Matrix, Magic and Sapiens.

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

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Revenues. Revenues increased 14% from \$365.8 million in 2005 to \$416.8 million in 2006. Revenues from the two categories of our operation were as follows: Revenues from the delivery of software services increased 16% from \$274.9 million in 2005 to \$320.0 million in 2006. This increase was attributable to the growth in Matrix's and nextSource's revenues due to an increased demand for their services. Revenues from the sale of proprietary software solutions in 2006 were \$96.9 million compared to \$90.9 million in 2005, an increase of 7%. This was due to an increase in Sapiens' revenues. Magic's revenues remained relatively the same in 2006 and 2005.

Cost of Revenues. Cost of revenues increased 16% from \$266.2 million in 2005 to \$309.4 million in 2006. As a percentage of revenues, cost of revenues was relatively at the same level in 2005 and in 2006, 73% and 74%, respectively. Cost of revenues for proprietary software solutions increased 13% to \$53.8 million in 2006 from \$47.7 million in 2005, primarily due to the increase in the cost of revenues of all of our proprietary software solutions subsidiaries. Cost of revenues for software services increased 17% from \$218.6 million in 2005 to \$255.6 million in 2006, primarily due to the increase in the cost of revenues of our subsidiaries Matrix and nextSource.

Software Development Costs, net. Software development costs, gross, remain at the same level in 2005 and 2006, \$14.5 million and \$14.0 million, respectively. In 2006, we capitalized software costs of \$8.5 million compared to \$8.4 million in 2005. Capitalization of software costs in 2006 was attributable to our proprietary software solutions subsidiaries. Software development costs, net, decreased from \$6.1 million in 2005 to \$5.5 million in 2006. As a percentage of revenues, software development costs, net remained at approximately the same level in 2006 and 2005, 1.3% and 1.7%, respectively. The decrease in software development costs was attributable primarily to Matrix and Sapiens. Amortization of capitalized software costs were \$8.9 million in 2006 and \$7.4 million in 2005, which amounts were included in cost of revenues.

Selling, General and Administrative Expenses. Selling, general and administrative expenses in 2006 and 2005 were \$88.8 million and \$86.7 million, respectively. As a percentage of revenues, selling, general and administrative expenses were 21% in 2006 and 24% in 2005. The increase in selling, general and administrative expenses was primarily attributable to an increase in selling, general and administrative expenses of Matrix which was offset by a decrease in selling, general and administrative expenses of Sapiens and Magic.

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Restructuring Costs. Restructuring costs in 2006 were \$2.9 million and were primarily attributable to restructuring activities of Magic, which had restructuring costs of \$2.1 million, and Sapiens which had restructuring costs of \$758,000. The restructuring costs of Magic resulted mainly from severance payments paid in connection with the restructuring and impairment plan announced by Magic in the third quarter of 2006, which aimed to reduce costs and improve profitability. Restructuring costs in 2005 were \$1.5 million and were primarily attributable to restructuring activities of Sapiens which had restructuring costs of \$1.1 million and Magic which had restructuring costs of \$342,000. The restructuring costs of Sapiens resulted from the lay-off of approximately 40 employees.

Operating Income. Our operating income increased from \$5.4 million in 2005 to \$10.1 million in 2006. The operating income in 2006 is attributable to the improvement in the operating results of our subsidiaries, and in particular Matrix, which had operating income of \$19.2 million and a decrease in the net operating loss of Sapiens, which had operating loss of \$1.3 million. The improvement was offset by the operating loss of \$6.7 million of Magic. The operating income in 2005 was attributable to the improvement in the operating results of our subsidiaries, and in particular Matrix, which had operating income of \$17.0 million and nextSource. The improvement in 2005 was offset by the operating loss of \$5.6 million of Magic and the operating loss of \$5.5 million of Sapiens.

Financial Expenses, net. Financial expenses, net increased from \$2.1 million in 2005 to \$4.7 million in 2006. The increase in financial expenses in 2006 resulted from interest expenses incurred by our subsidiaries, and in particular, Sapiens which had financial expenses of \$2.2 million. This increase in our financial expenses was offset by a decrease in the financial expenses of Matrix and Magic.

Other income (expenses), net. Other expenses, net in 2006 were \$1.1 and other income, net in 2005 was \$341,000.

Gain on Realization of Shareholdings. Gain on realization of shareholdings in 2006 was \$3.7 million compared to \$3.2 million in 2005. Gain on realization of shareholdings in 2006 was attributable primarily to the sale by Matrix of its holdings in Matrix One and the decrease in the percentage of shareholdings by Matrix of its subsidiary, Tiltan, which resulted in aggregate consideration of approximately \$4.0 million. Gain on realization of shareholdings in 2005 was attributable to the sale of a portion of the shares of Matrix in the open market which resulted in gain to Formula of \$1.7 million, and gain from a decrease in our shareholding in Matrix due to the conversion of Matrix debentures into shares by third parties which resulted in gain to Formula of \$1.6 million.

Taxes on Income. Taxes on income in 2006 were \$3.8 million compared to \$4.7 million in 2005. The decrease in taxes on income in 2006 was mainly attributable to the decrease in taxes of Sapiens.

Company's Equity in Results of Affiliates, net. Our equity in gains of affiliates, net were \$47,000 in 2006 compared to \$62,000 in 2005.

Minority Interest, net. Minority interest in profits of subsidiaries in 2006 was \$4.8 million compared to minority interest in losses of subsidiaries of \$189,000 in 2005. This change was primarily attributable to the improvement in the results of certain of our subsidiaries.

Impact of Inflation and Currency Fluctuations on Results of Operations

A significant portion of our worldwide sales are currently denominated in dollars and euros., while a substantial portion of our expenses, principally salaries and related personnel expenses, are in New Israeli Shekels (NIS). As a result, a decrease in the value of the dollar or euro relative to other foreign currencies, in particular the NIS would increase our operating costs and, therefore, could adversely affect our results and harm our competitive position in the markets. In recent periods, the value of the dollar and the euro was decreased significantly in relation to the NIS. We cannot know whether this trend would continue in the future. If the dollar or euro value in relation to the NIS continues to decrease, our operating costs would increase, and in turn, our results of operation may be harmed. To date, we have not engaged in significant hedging transactions. In the future, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar or euro against the NIS. However, we cannot assure you that these measures will adequately protect us from material adverse effects arising from the impact of inflation in Israel.

Following is a summary of the most relevant monetary indicators for the reported periods:

For the year ended December 31,	Inflation rate in Israel %	Devaluation of NIS against the US\$ %	Devaluation of euro against the US\$ %
2005	2.4	6.8	13.3
2006	(0.1)	(8.2)	(11.3)
2007	3.4	(8.7)	(11.7)

B. Liquidity and Capital Resources

Since inception, we have financed our growth and business primarily through cash provided by operations and through public debt and equity offerings, as well as through private and public debt and equity offerings of our subsidiaries. In addition, we finance our business through short-term and long-term loans and borrowings available under our credit facilities.

Cash

At December 31, 2007 we had cash and cash equivalents and short-term investments of \$201.8 million and at December 31, 2006, we had cash and cash equivalents and short-term investments of \$118.6 million. At December 31, 2007, we had indebtedness to banks and others of \$50.6 million, of which \$27.0 million was current liabilities and \$23.7 million was long-term liabilities. At December 31, 2006, we had indebtedness to banks and others of \$99.7 million, of which \$40.4 million was current liabilities and \$59.3 million was long-term liabilities.

Our subsidiaries maintain credit facilities with banks in accordance with their cash requirements. These credit facilities include, inter alia, certain covenants related to their operations, such as maintaining a minimum level of shareholders' equity and reaching certain operating results targets. Some of our subsidiaries' assets are pledged to the lender banks. If any of our subsidiaries does not meet the covenants specified in its credit agreement, and a waiver with respect to the fulfillment of such covenant has not been received from the lender bank, the lender bank may foreclose on the pledged assets to satisfy the debt.

Cash flow provided by operating activities in 2007 was \$43.2 million compared to cash flow provided by operating activities of \$26.0 million in 2006. Cash flow provided by operating activities in 2007 was primarily comprised of \$23.2 million provided by Matrix, \$7.1 million by Sapiens and \$7.9 million by Magic. Cash flow provided by operating activities in 2006 was primarily comprised of \$15.0 million provided by Matrix, and \$10 million provided by BluePhoenix.

Financing activities

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Cash flow provided by financing activities in 2007 was \$12.9 million compared to cash flow used in financing activities of \$4.0 million in 2006. This was mainly the result of the following transactions:

In August 2007, Matrix completed an offering of debentures to institutional and other investors in Israel, in an aggregate principal amount of approximately \$62.0 (NIS 250 million). In February 2008, Matrix listed the debentures for trading on the TASE.

In June 2007, Sapiens entered into a private placement investment transaction with several institutional investors, private investors and Formula for an aggregate gross investment amount of \$20 million (excluding finders' fees and out of pocket expenses), \$6.5 million of which was by Formula.

In 2007, Matrix distributed to its shareholders a cash dividend in the aggregate amount of approximately \$14.1 million, of which \$6.4 million was received by Formula.

During 2007, Formula and certain of our subsidiaries repaid long-term loans to banks of approximately \$61.6 million, of which \$50.9 million was repaid by Formula and \$9.4 million was repaid by Matrix.

During 2007, Formula and certain of our subsidiaries repaid short-term loans to banks of approximately \$16.9 million, of which \$5.4 million was repaid by Formula, \$4.8 million was repaid by Matrix and \$4.6 million was repaid by Sapiens.

In 2007, Sapiens re-purchased an aggregate amount of NIS 15 million nominal value of its debentures, representing approximately \$3.5 million. In addition, Sapiens paid to its debentures holders \$4.4 million representing the second payment of the principal of the debentures (Series A).

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In December 2006, Formula distributed to its shareholders a dividend consisting of 36,696,000 shares of Formula Vision held by Formula and representing approximately 57% of the outstanding share capital of Formula Vision. Formula Vision shares were distributed at a ratio of 2.78 shares of Formula Vision for every one outstanding ordinary share of Formula, prior to withholding taxes. As a result, we no longer hold an interest in Formula Vision.

On December 31, 2006, Formula Vision paid approximately \$51 million to us, as a full repayment of the principal and interest owed to us by Formula Vision.

In April 2006, we repaid the outstanding amount of the debentures issued by us to FIMI and IDB. The aggregate amount repaid by us was approximately \$3.6 million.

In March 2006, BluePhoenix completed a \$3 million follow-on private placement of convertible debentures and warrants to certain institutional investors, who previously invested in BluePhoenix in 2004.

In March 2006, Matrix distributed to its shareholders a cash dividend in the aggregate amount of approximately \$3.0 million, of which \$1.5 million was received by Formula.

In February 2006, BluePhoenix completed a public offering in Israel of convertible debentures convertible into BluePhoenix ordinary shares, resulting in gross proceeds to BluePhoenix of approximately \$11.5 million.

In 2006, Formula and certain of our subsidiaries received long-term loans of approximately \$31.4 million from banks, of which \$11.8 million was received by Formula, \$14.4 million by BluePhoenix and \$4.9 million by Matrix.

In 2006, our subsidiaries repaid long-term loans to banks and others of approximately \$9.7 million of which \$8.0 million was repaid by Matrix and \$1.1 million by Sapiens.

Recent financing activities

In April 2008, Formula distributed to its shareholders a cash dividend of approximately \$0.76 per share. The aggregate amount distributed by Formula was approximately \$10 million.

Investing activities

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In 2007, net cash used in investing activities was \$18.8 million and in 2006, net cash provided by investing activities was \$6.2 million. These investing activities were comprised of the following transactions:

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In June 2007, we completed the sale of our entire shareholdings in BluePhoenix to international institutional investors for aggregate consideration of approximately \$64 million.

In 2007, we purchased in the open market shares of several of our subsidiaries as follows: 1,231,563 shares of Matrix for aggregate consideration of \$4.3 million, 503,473 shares of Magic for aggregate consideration of \$1.0 million and 195,107 shares of Sapiens for aggregate consideration of \$326,535.

In 2007, Matrix purchased marketable securities for aggregate consideration of \$26.3 million

In 2007, our subsidiaries capitalized software development costs and other costs in an aggregate amount of \$8.5 million.

In February 2006, Formula Vision sold certain of its holdings in its affiliate, FIS Software Ltd., to a third party for a consideration of \$4.0 million.

In February 2006, Formula Vision sold the activities of its subsidiary T-Soft Ltd. for a consideration of \$3.0 million.

In March 2006, Formula Vision sold certain of its holdings in its affiliate Transtech Ltd. to a third party for a consideration of \$8.75 million.

In April 2006, Formula Vision paid to FIMI and IDB \$5.4 million in accordance with agreements between the parties.

In August 2006, we invested \$2.0 million in Sapiens in consideration for 1,562,500 common shares of Sapiens issued to us by Sapiens.

In 2006, we purchased in the open market shares of several of our subsidiaries as follows: 624,216 shares of Matrix for aggregate consideration of \$1.9 million, 3,622,697 shares of Formula Vision for aggregate consideration of \$1.3 million and 252,400 shares of Sapiens for aggregate consideration of \$336,686.

In 2006, we converted warrants of Matrix into 704,592 shares of Matrix for consideration of \$1.3 million.

In 2006, our subsidiaries capitalized software development costs and other costs in an aggregate amount of \$18.8 million.

We believe that the net cash proceeds we raised by financing activities, together with cash flows from operating activities, will be sufficient to meet our cash needs for the next 12 months at the current level of operations. We will consider in the future additional equity issuances, debt issuances or borrowings from banks if necessary to meet cash needs for our growth.

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Commitments and Contingent Liabilities

Some of our subsidiaries have floating charges in favor of banks and other financial institutions. In addition, some of our subsidiaries have liens on leased vehicles, leased equipment and other assets in favor of the leasing companies.

Other Contractual Commitments

We entered into an undertaking to indemnify our office holders in specified limited categories of events and in specified amounts, subject to certain limitations. For more information, see Item 7. Major Shareholders and Related Party Transactions Related Party Transactions Indemnification of Office Holders.

Related Party Transactions

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On December 31, 2006, Formula Vision paid approximately \$51 million to us, as a full repayment of the principal of the debentures issued by Formula Vision to Formula in 2001 and 2002, including interest accrued thereon.

Effective Corporate Tax Rates in Israel

Law for the Encouragement of Capital Investments, 1959

Certain of the companies in the Formula Group have been granted Approved Enterprise status under the Law for the Encouragement of Capital Investments, 1959, known as the Investment Law. Accordingly, if these companies comply with certain requirements, they are eligible for certain tax benefits for the first seven years in which they generate taxable income. Income derived from these companies' Approved Enterprise programs will be tax exempt for a period of two years after the companies have taxable income. They will also be subject to a 25% company tax rate for the following five years. Under certain circumstances, if the percentage of the share capital that foreign shareholders hold in subsidiaries and affiliates of these companies exceeds 25%, future Approved Enterprises of the applicable subsidiary or affiliate would qualify for reduced tax rates for an additional three years, after the seven years mentioned above. We cannot assure you that these companies will obtain approval for additional Approved Enterprises, that the provisions of the Investment Law will not change, or that the above-mentioned shareholding portion will be reached or maintained for each subsequent year.

On April 1, 2005, the Israeli Parliament passed an amendment to the Investment Law, in which it revised the criteria for investments qualified to receive tax benefits. An eligible investment program under the amendment will qualify for benefits as a privileged enterprise (rather than the previous terminology of approved enterprise). Among other things, the amendment provides tax benefits to both local and foreign investors and simplifies the approval process. If the investment programs of the Formula Group companies comply with the requirements of the law, they will be entitled to certain tax benefits. We cannot assure you that any additional investment program adopted by any of these companies in the future will comply with the requirements of the law or that the tax benefits for investment programs continue at current levels.

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Corporate Tax

Following the tax reform enacted in 2003, an Israeli company is subject to tax on its worldwide income. An Israeli company that is subject to Israeli taxes on the income of its non-Israeli subsidiaries will receive a credit for income taxes paid by the subsidiary in its country of residence. Israeli tax payers are also subject to tax on income from a controlled foreign corporation, according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary, if such subsidiary's primary source of income is a passive income (such as interest, dividends, royalties, rental income, or capital gains).

On January 1, 2006, an additional tax reform took place relating primarily to profits from investments. The main goal of the reform was to unify the tax rates applicable to profits from investments, such as interest, capital gains, and dividends. In addition, under the new reform, the tax rates applicable to companies were reduced to 29% in 2007, 27% in 2008, 26% in 2009, and 25% from 2010 and on.

Our international operations are taxed at the local effective corporate tax rate in the countries of our subsidiaries' residence. In the future we may derive an increasing percentage of our income from operations outside of Israel. If that occurs, our effective tax rate may increase. However, we expect that this increase will be offset by carried forward accumulated losses of consolidated companies.

C. Research and Development, Patents and Licenses

In 2007, we spent \$6.5 million on research and development activities, in 2006 we spent \$5.5 million and in 2005 we spent \$6.1 million. The increase in the amount spent on research and development activities in 2007 compared to 2006 relates primarily to an increase in research and development expenditures of Sapiens. The decrease in the amount spent on research and development activities in 2006 compared to 2005 resulted from a decrease in the development expenditures of Sapiens and Matrix in 2006. For more information about our research and development activities, see Item 4. Information on the Company Business Overview Software Development.

For information concerning our intellectual property rights, see Item 4. Information on the Company Business Overview Intellectual Property Rights.

D. Trend Information

Economic changes such as the U.S. subprime mortgage loan crisis and the economic instability caused by the rise in oil prices, are affecting companies' willingness, in both the U.S. and in Europe, to make capital spending on IT projects. We cannot know whether IT capital spending and investment in IT projects will continue in the future at the same level, or how the economic conditions will affect our business. Accordingly, we cannot assure you that we will be able to increase our revenues or keep our revenues at the same level as in 2007. As we continue to market new products and penetrate international markets, we expect our selling, general and administrative expenses to continue to be relatively high.

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E. Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

F. Tabular Disclosure of Contractual Obligations

The following table summarizes our contractual obligations and commitments as of December 31, 2007.

	Payments due by period					Other (1)
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years	
\$ in thousands						
Long-term debt obligations (2)	109,263	13,698	20,723	74,842	--	--
Lease obligations	40,961	18,902	19,673	2,045	341	--
Liability in respect of the acquisition of activities	1,583	210	420	420	420	113
Other long-term liabilities reflected on our balance sheet under U.S. GAAP	5,923	--	--	--	--	5,923
Total	\$ 157,730	\$ 32,810	\$ 40,816	\$ 77,307	\$ 761	\$ 6,036

(1) Other obligations include severance pay which was not funded by the Company, the due date of which is unknown.

(2) Does not include accrued interest.

G. Safe Harbor

The safe harbor provided in Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended, referred to as the Exchange Act, shall apply to forward-looking information provided in Items 5.E and F.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**A. Directors and Senior Management**

The following table describes information about our directors and senior management as of June 20, 2008.

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Name	Age	Position
Guy Bernstein	40	Chief Executive Officer and Director
Naamit Salomon	44	Chief Financial Officer
Shimon Laor	39	Director
Tal Barnoach	45	Director
Hadas Gazit Kaiser	32	Director
Dr. Shlomo Nass	48	Director
Dr. Ronnie Vinkler (1)	62	Director
Ofer Lavie (1)	63	Director

(1) Outside director. See Item 6. Directors, Senior Management and Employees Board Practices Outside Directors; Audit Committee; Internal Auditor; Approval of Certain Transactions Under the Companies Law, below.

Guy Bernstein has served as one of our directors since November 2006 and was appointed our chief executive officer in January 2007. Since December 2006, Mr. Bernstein has served as the chief executive officer of Emblaze, our controlling shareholder, a publicly-traded company listed on the AIM, the London Stock Exchange. Mr. Bernstein also serves as a director of Sapiens and he is the chairman of the board of Matrix and Magic. From April 2004 to December 2006, Mr. Bernstein served as the chief financial officer of Emblaze and he has served as a director of Emblaze since April 2004. Prior thereto, Mr. Bernstein served as the chief financial and operations officer of Magic, a position he held since 1999. He joined Magic from Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, where he acted as senior manager from 1994 to 1997. Mr. Bernstein holds a B.A. degree in accounting and economics from Tel Aviv University and is a certified public accountant in Israel.

Naamit Salomon has served as our chief financial officer since 1997. Ms. Salomon also serves as a director of Magic and Sapiens. From 1990 through August 1997, Ms. Salomon was a controller of two large, privately-held companies in the Formula Group. Ms. Salomon holds a B.A. degree in economics and business administration from Ben Gurion University and an LL.M. degree from the Bar-Ilan University.

Shimon Laor has served as one of our directors since November 2006. He also served as a director of Emblaze and as its chief financial officer from 1995 to 2000. Since then, he has been engaged in private business initiatives. Mr. Laor also serves as a director of Emblaze VCON Ltd. and Visual Defence Inc., partially-owned subsidiaries of Emblaze. Prior to joining Emblaze in August 1995, Mr. Laor served as an economist at the head office foreign currency division of the First International Bank of Israel. Mr. Laor holds a B.A. degree in economics and accounting from Tel Aviv University.

Tal Barnoach has served as one of our directors since November 2006. Since 1994, Mr. Barnoach has served as chairman and chief executive officer of S.E.A. Multimedia, a publicly-traded company listed on the AIM. In addition, he serves as the chief executive officer of BeInSync, a company he co-founded in 2002. Mr. Barnoach also serves as the executive vice chairman of zone IP of Emblaze. Since 1999, Mr. Barnoach has served as chairman of Orca Interactive Ltd. Mr. Barnoach holds a B.A. degree in economics from Tel Aviv University.

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Hadas Gazit Kaiser has served as one of our directors since March 2007. Ms. Gazit Kaiser has served as the chief financial officer and finance director of Emblaze since December 2006. During 2005 and 2006, she served as the vice president, finance of Emblaze and the chief financial officer of Emblaze Mobile. From 2003 to 2005, Ms. Gazit Kaiser served as the budget control manager of TTI Team Telecom International Ltd., a NASDAQ-listed company. Prior thereto, Mrs. Gazit Kaiser acted as a manager at Kost, Forer Gabbay & Kasierer. Mr. Gazit Kaiser is a director of Magic, Sapiens, Matrix and Rad View Software Ltd. Ms. Gazit Kaiser holds a B.A. degree in economics and accounting

and an M.B.A. degree in finance, both from Tel Aviv University, and she is a certified public accountant in Israel.

Dr. Shlomo Nass has served as one of our directors since April 2003. Dr. Nass is a senior partner at Dr. Shlomo Nass and Co. Ltd., and a president of and a partner in I.G.B. Israel Global Business, an investment group. Mr. Nass performed various public duties and serves as a director of I.G.B., IRS-TKB International Consultants Ltd., Mivnei Taasiya Ltd., Ayalon Insurance Company Ltd., TAO, N.M.C. and Yuli Shukei Hon Ltd. Mr. Nass holds a B.Sc. degree in economics and accounting, an LL.B. degree, and a Ph.D degree in law, all from Bar-Ilan University. He is a certified public accountant in Israel and a member of the Israel Bar.

Dr. Ronnie Vinkler has served as one of our outside directors since March 2007. Dr. Vinkler is an independent business development and management analysis consultant. He has many years of experience in the Hi-tech industry, projects management and research and development. Dr. Vinkler also serves as a director of Mofet Israel Technology Fund Ltd. In 2002 and 2003, Dr. Vinkler served as general manager of Icom Mobile (Israel). From 2000 to 2002, he served as general manager of B.I.S. Advanced Software Solutions Ltd. Dr. Vinkler holds a B.Sc. degree in Aeronautical Engineering and Industrial Engineering and Management from the Technion, Israel Institute of Technology, and a M.Sc. and Ph.D in Aeronautical Engineering from Caltech, California Institute of Technology.

Ofer Lavie has served as one of our outside directors since March 2007. Mr. Lavie is an independent financial business development consultant. From 1999 to 2005, Mr. Lavie served as the chief financial officer of Metalink Ltd., a public company listed on the NASDAQ Global Market and the TASE. Mr. Lavie also serves as a director of Yozma Pension Fund for Self Employed Ltd., a Migdal Group fund, and of Alpa Cosmetics Ltd. Mr. Lavie also serves as an outside director of Procognia (Israel) Ltd., a public company traded on the TASE. In addition, Mr. Lavie serves as the chief executive officer of the Education Center in the CFO Forum in Israel. Mr. Lavie holds a B.Sc. degree in economics from Tel Aviv University.

B. Compensation

In 2007, we paid to our directors and officers (nine persons) aggregate direct remuneration of approximately \$2.6 million. This amount includes amounts set aside or accrued to provide post-employment benefits.

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This amount does not include the following:

amounts expended by us for automobiles made available to our officers;

expenses, including business travel, professional and business association dues and expenses, that we reimburse our officers for; and

other fringe benefits that companies in Israel commonly reimburse or pay to their officers.

The amount also includes payment of directors' fees to our outside directors and Mr. Shlomo Nass. We compensate our outside directors in accordance with the regulations promulgated under the Israeli Companies Law, 1999, referred to as the Companies Law. We compensate Mr. Shlomo Nass in such amounts specified in the regulations.

Our employee directors do not receive fees for their services as directors. In 2007, we paid an aggregate amount of \$61,200 for post-employment benefits for our executive officers and directors. Under Israeli law, we are not required to disclose, and have not otherwise disclosed, the compensation of our senior management and directors on an individual basis.

Generally, we enter into written employment agreements with our executive officers pursuant to which, among other things, we pay them a monthly salary in an agreed amount. The salary is linked to the Israeli CPI. Each party may terminate the agreement upon 3 to 6 months prior notice. If we terminate any of these employment agreements, we will have to pay the usual severance pay required under Israeli law for all employees.

In January 2008, we entered into a service agreement with Mr. Guy Bernstein, our chief executive officer and director. Under this agreement, beginning in 2008, Mr. Bernstein shall be entitled to an annual bonus in an amount equal to 3.3% of our net profit (including capital gains) after tax. An advance of 70% of the bonus shall be paid quarterly, based on our quarterly financial statements, subject to final adjustment at the end of each year. The aforementioned bonus shall be paid to Mr. Bernstein so long as he serves in a senior leading position with Formula,

whether as an active chairman, president or otherwise (after he ceases to serve as our chief executive officer). In the event that we terminate our relationship with Mr. Bernstein in a senior leading position, Mr. Bernstein shall be paid the remaining 30% for the past quarters and an additional payment in an amount equal to 100% of the bonus for the next two quarters, based on our net profit in the two quarters prior to the notice of termination. Under the terms of the service agreement, Mr. Bernstein shall be entitled to a 180-day prior notice of termination. Mr. Bernstein was granted, for his services as a director, options to purchase 198,000 ordinary shares, each exercisable at an exercise price of NIS 60 per share (not linked to the CPI) (approximately \$16.35). The options vest over a four-year period, commencing on the date of Mr. Bernstein's appointment to serve as a director (*i.e.* November 20, 2006), on a quarterly basis. The options shall expire six years of the date of grant. The terms of Mr. Bernstein's employment were approved by the general meeting of shareholders, following the approval of our audit committee and board of directors.

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In addition, in light of the active role taken by Mr. Bernstein in our operations during his service as active chairman of the board, in 2007, our shareholders approved, following our audit committee and board approval, the payment to Mr. Bernstein of a one-time bonus in an amount equal to 3.3% of our net profit (including capital gains) after tax, for the year ended December 31, 2007, as compensation for his services as chairman of the board during the abovementioned period.

C. Board Practices

Pursuant to our articles of association, directors are elected at the annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented at the meeting. Our board is comprised of 7 persons, of which the following three have been determined by the board to be independent within the meaning of the applicable NASDAQ requirements: Shlomo Nass, Ronnie Vinkler and Ofer Lavie. The board includes two outside directors mandated under Israeli law and subject to additional criteria to help ensure their independence. See *Outside Directors* below. Each director, except for the outside directors, holds office until the next annual general meeting of shareholders. Officers are appointed by our board of directors. For information regarding the employment agreements of our officers, see *Item 6. Directors, Senior Management and Employees Compensation*.

Companies trading on The NASDAQ Global Market are generally required to have a majority of their board members be independent. We are exempt from this requirement under the *controlled company* exemption because more than 50% of our voting power is held by Emblaze.

Outside Directors

Under the Companies Law, companies incorporated under the laws of Israel whose shares have been offered to the public in or outside of Israel, are required to appoint at least two outside directors. This law provides that a person may not be appointed as an outside director if the person or the person's relative, partner, employer or any entity under the person's control, has, as of the date of the person's appointment to serve as outside director, or had, during the two years preceding that date, any affiliation with the company or any entity controlling, controlled by or under common control with the company. The term *affiliation* includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder.

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No person may serve as an outside director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director or if the person is an employee of the Israel Securities Authority or of an Israeli stock exchange. If, at the time of election of an outside director, all other directors are of the same gender, the outside director to be elected must be of the other gender. Outside directors are to be elected by a majority vote at a shareholders' meeting, provided that either:

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the majority of shares voted at the meeting, including at least one-third of the shares of non-controlling shareholders voted at the meeting, vote in favor of election of the director; or

the total number of shares of non-controlling shareholders voted against the election of the director does not exceed one percent of the aggregate voting rights in the company.

Pursuant to the Companies Law, all outside directors must have financial and accounting expertise or professional qualifications, and at least one outside director must have financial and accounting expertise. The terms financial and accounting expertise and professional qualifications are defined in regulations promulgated under the Companies Law. Our audit committee member, Ronnie Vinkler, is considered to have the required professional qualifications and Shlomo Nass has financial and accounting expertise.

The initial term of an outside director is three years and may be extended by the general meeting of shareholders, for an additional three years. In March 2007, Mr. Ronnie Vinkler and Mr. Ofer Lavie were appointed as our outside directors, each to hold office until March 2010. In accordance with the Israeli Companies Regulations (Alleviation for Public Companies Whose Shares are Listed on a Stock Exchange Outside of Israel) 2000, dual listed companies, like us, may re-appoint an outside director for additional three-year terms, above the maximum six-year term permitted under the Companies Law, if the audit committee and the board of directors confirm that due to the expertise and special contribution of the outside director to the work of the board and its committees, his re-appointment is in the best interests of the company.

Each committee of a company's board of directors is required to include at least one outside director and the audit committee must include all the outside directors.

An outside director is entitled to compensation as provided in regulations promulgated under the Companies Law and is otherwise prohibited from receiving any compensation, directly or indirectly, in connection with services provided as an outside director.

Qualifications of Other Directors

Under the Companies Law, the board of directors of a publicly traded company is required to make a determination as to the minimum number of directors who must have financial and accounting expertise according to criteria that is defined in regulations promulgated under the Companies Law, effective as of January 2006. In accordance with the Companies Law, the determination of the board should be based on, among other things, the type of the company, its size, the volume and complexity of its activities and the number of directors. Based on the foregoing considerations, our board determined that the number of directors with financial and accounting expertise in our company shall not be less than one.

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Audit Committee

The Companies Law requires public companies to appoint an audit committee, comprised of at least three directors, including all of the outside directors. The chairman of the board of directors, any director employed by or otherwise providing services to the company, and a controlling shareholder or any relative of a controlling shareholder, may not be a member of the audit committee.

In addition, under applicable NASDAQ rules, we are currently required to have at least three independent directors and to maintain an audit committee, whose members are independent of management. We have established an audit committee, consisting of our two outside directors, Ronnie Vinkler and Ofer Lavie, as well as Shlomo Nass. Each audit committee member qualifies as an independent director under the applicable NASDAQ rules and those of the SEC. The board has determined that Shlomo Nass is an audit committee financial expert as defined by applicable SEC regulations. See Item 16. Audit Committee Financial Expert.

Under the Companies Law, the audit committee is responsible for overseeing the business management practices of the company in consultation with the company's internal auditor and the independent auditor, making recommendations to the board to improve such practices and approving related party transactions as required by the Companies Law. In accordance with the Sarbanes-Oxley Act and NASDAQ requirements, our audit committee is directly responsible for the appointment, compensation, retention and oversight of our independent auditors, subject to shareholder approval as required under Israeli law. In addition, the audit committee is responsible for assisting the board in monitoring our financial statements and the effectiveness of our internal controls. We have adopted a formal audit committee charter that we have implemented, embodying these responsibilities.

Internal Auditor

Under the Companies Law, the board of directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether the company's actions comply with the law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an office holder, or an interested party (*i.e.*, a holder of 5% or more of the voting rights in the company or of the issued share capital, the chief executive officer of the company or any of its directors, or a person who has the authority to appoint the company's chief executive officer or any of its directors), or a relative of an office holder or of an interested party. In addition, the company's independent auditor or its representative may not serve as the company's internal auditor.

Exculpation, Insurance and Indemnification of Directors and Officers

Under the Companies Law, an Israeli company may not exempt an office holder from liability with respect to a breach of his duty of loyalty, but may exempt in advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care, provided, however, that such a breach is not related to a distribution of a dividend or any other distribution by the company.

Office Holders Insurance. Our articles of association provide that, subject to the provisions of the Companies Law, we may enter into a contract for the insurance of the liability of any of our office holders imposed on the office holder in respect of an act performed in his or her capacity as an office holder, with respect to:

a breach of his duty of care to us or to another person;

a breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or

a financial liability imposed upon him in favor of another person.

We have obtained an insurance policy covering the Formula Group's directors' and officers' liability. Our subsidiaries participate in the premium payments of the insurance, on a proportional basis. The total premium we paid during 2007 was approximately \$200,000.

Indemnification of Office Holders. Our articles of association provide that we may indemnify an office holder in respect of an obligation or expense imposed on or expended by an office holder in respect of an act performed in his capacity as an office holder as specified below:

- (i) a financial liability imposed on him in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court;
- (ii) reasonable litigation expenses, including attorney's fees, expended by the office holder as a result of an investigation or proceeding instituted against him by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against him, and either (i) concluded without the imposition of any financial liability in lieu of criminal proceedings; or (ii) concluded with the imposition of a financial liability in lieu of criminal proceedings but relates to a criminal offense that does not require proof of criminal intent; and
- (iii) reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him by a court, in proceedings instituted against him by another person, or in a criminal charge from which he was acquitted or in any criminal proceedings of a crime which does not require proof of criminal intent in which he was convicted.

We may undertake to indemnify an office holder as aforesaid, (a) prospectively, provided that in respect of (i) above, the undertaking is limited to categories of events that in the opinion of our board of directors are foreseeable in light of the company's operations at the time that the undertaking to indemnify is given, and for an amount or criteria that our board has determined as reasonable under the circumstances, and further provided that such events and amount or criteria are indicated in the indemnification undertaking, but in any event no more than 25% of Formula's shareholders equity according to its most recent financial statements as of the date of the actual payment of indemnification; and (b) retroactively.

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Limitations on Exemption, Insurance and Indemnification. The Companies Law provides that a company may not indemnify an office holder, enter into an insurance contract which would provide coverage for any monetary liability, or exempt an office holder from liability, with respect to any of the following:

a breach by the office holder of his duty of loyalty unless the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;

a breach by the office holder of his duty of care if the breach was done intentionally or recklessly, except for a breach that was made in negligence;

any act or omission done with the intent to derive an illegal personal benefit; any fine levied against the office holder; or

a counterclaim made by the company or in its name in connection with a claim against the company filed by the office holder.

In addition, under the Companies Law, indemnification of, and procurement of insurance coverage for, our office holders must be approved by our audit committee and our board of directors and, in specified circumstances, by our shareholders.

We have entered into an undertaking to indemnify our office holders in specified limited categories of events and in specified amounts, subject to the limitations set by the Companies Law and our articles of association, as described above. For more information, see Item 7.B. Related Party Transactions – Indemnification of Office Holders.

Approval of Certain Transactions Under the Companies Law

The Companies Law codifies the fiduciary duties that office holders, including directors and executive officers, owe to a company. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. The duty of loyalty includes (i) avoiding any conflict of interest between the office holder's position in the company and his personal affairs, (ii) avoiding any competition with the company, (iii) avoiding exploiting any business opportunity of the company in order to receive personal advantage for himself or others, and (iv) revealing to the company any information or documents relating to the company's affairs which the office holder has received due to his position as an office holder. Each person listed in the table under Directors and Senior Management above is an office holder. Under the Companies Law, arrangements regarding the compensation of directors require the approval of the audit committee, the board of directors and shareholder approval.

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The Companies Law requires that an office holder of a company promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. In addition, if the transaction is an extraordinary transaction as defined under the Companies Law, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing. In addition, the office holder must also disclose any interest held by any corporation in which the office holder owns 5% or more of the share capital, is a director or general manager or in which he or she has the right to appoint at least one director or the general manager. An extraordinary transaction is defined as a transaction other than in the ordinary course of business, otherwise than on market terms, or that is likely to have a material impact on the company's profitability, assets or liabilities.

Under the Companies Law, after the office holder complies with the disclosure requirements described above, only board approval is required for any transaction which is not an extraordinary transaction, unless the articles of association of the company provide otherwise, and provided the transaction is not adverse to the company's interest. If the transaction is an extraordinary transaction, the company must receive any approval stipulated by the articles of association, the approval of the company's audit committee and the approval of the board of directors, as well as, under certain circumstances, approval by a meeting of the shareholders of the company. An office holder who has a personal interest in a matter which is considered at a meeting of the board of directors or the audit committee may not be present at this meeting or vote on this matter unless the majority of the board members or members of the audit committee, as applicable, have a personal interest in such matter and in such case, the matter should also be approved by the shareholders of the company.

The Companies Law applies the same disclosure requirements to a controlling shareholder of a public company, which includes a shareholder that holds 25% or more of the voting rights in the company if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder or its relative who is an office holder or an employee of the company, require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval must include at least one-third of the

shareholders who have no personal interest in the transaction and are voting on the subject matter or, alternatively, the total shareholdings of those who have no personal interest in the transaction who vote against the transaction must not represent more than one percent of the voting rights in the company. In certain cases provided in regulations promulgated under the Companies Law, shareholder approval is not required.

The approvals of the board of directors and shareholders is required for a private placement of securities (or a series of related private placements during a 12-month period or that are part of one continuous transaction or transactions conditioned upon each other) in which:

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the securities issued represent at least 20% of the company's actual voting power prior to the issuance of such securities, and such issuance increases the relative holdings of a 5% shareholder or causes any person to become a 5% shareholder, and the consideration in the transaction (or a portion thereof) is not in cash or in securities listed on a recognized stock exchange, or is not at a fair market value; or

a person would become, as a result of such transaction, a controlling shareholder of the company.

D. Employees

We have approximately 4,950 full-time employees, of whom approximately 4,260 are software professionals. Most of our employees are located in Israel and the other in the United States, Europe and other places abroad. In 2006, we had approximately 5,290 full-time employees, of whom approximately 4,550 were software professionals. In 2005, we had approximately 4,090 full-time employees, of whom approximately 3,520 were software professionals. The decrease in the number of employees in 2007 compared to 2006 related primarily to the decrease in the number of employees in Magic, Sapiens and ,in particular, nextSource, which was offset by an increase in the number of employees in Matrix. The increase in the number of employees in 2006 compared to 2005 related primarily to the increase in the number of employees in Matrix and, in particular, nextSource, which was offset by a decrease in the number of employees in Magic and Sapiens.

With respect to our employees in Israel, we are subject to various Israeli labor laws and labor practices, and to administrative orders extending certain provisions of collective bargaining agreements between the Histadrut (Israel's General Federation of Labor) and the Coordinating Bureau of Economic Organizations (the Israeli federation of employers' organizations) to all private sector employees. For example, mandatory cost of living adjustments, which compensate Israeli employees for a portion of the increase in the Israeli consumer price index, are determined on a nationwide basis. Israeli law also requires the payment of severance benefits upon the termination, retirement or death of an employee. We meet this requirement by (i) contributing on an ongoing basis towards managers' insurance funds that combine pension, insurance and, if applicable, severance pay benefits and (ii) payment of differences, if applicable. In addition, Israeli employers and employees are required to pay specified percentages of wages to the National Insurance Institute. Other provisions of Israeli law or regulation govern matters such as the length of the workday, minimum wages, other terms of employment and restrictions on discrimination. We are also subject to the labor laws and regulations of other jurisdictions in the world where we have employees.

E. Share Ownership

As of June 20, 2008, none of our directors and officers had a share ownership in our company, nor did they hold options to purchase shares, except for Mr. Guy Bernstein, our chief executive officer and director, as described below.

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Mr. Bernstein was granted, for his services as a director, options to purchase 198,000 ordinary shares, each exercisable at an exercise price of NIS 60 per share (approximately \$16.35). The options vest over a four-year period, commencing on the date of Mr. Bernstein's appointment to serve as a director (*i.e.* November 20, 2006), on a quarterly basis. The options shall expire six years of the date of grant. As of June 20, 2008, Mr. Bernstein is the beneficial owner of 74,250 ordinary shares underlying currently exercisable options or options exercisable within 60 days of the date of this annual report.

Arrangements Involving the Issue or Grant of Options to Purchase Shares*Formula's 2008 Share Option Plan*

In March 2008, our shareholders approved the adoption of Formula's 2008 Employee and Office Holders Share Option Plan, referred to as the plan. Pursuant to the plan, we may grant from time to time to our and our subsidiaries' employees and office holders (which are not Formula's controlling shareholders) options to purchase up to 400,000 ordinary shares of Formula. The plan is administered by our board of directors. The plan provides that options may be granted, from time to time, to such grantees to be determined by the board, at an exercise price and under such terms to be determined at their sole and absolute discretion. Options may be granted under the plan through January 2018.

Of the options available for grant under the plan, we granted in March 2008, options to purchase 198,000 ordinary shares to our chief executive officer and director, each exercisable at an exercise price of \$16.35 (60 NIS). For more information, see Item 6.B. Compensation.

Option Plans of Our Subsidiaries

Our operating subsidiaries generally have share option plans pursuant to which qualified directors, employees and consultants may be granted options for the purchase of securities in these subsidiaries. In addition, these subsidiaries may from time to time grant options to third parties as part of a business transaction.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**A. Major Shareholders**

The following table presents information regarding the ownership of our ordinary shares at June 20, 2008 by each person known to us to be the beneficial owner of more than 5% of our ordinary shares based on information provided to us by the holders or disclosed in public filings with the SEC. None of the holders of the ordinary shares listed in this table have voting rights different from other holders of our ordinary shares. Except where we have indicated otherwise, we believe, based on information furnished by these owners, that the beneficial owners of our shares listed below have sole investment and voting power with respect to the shares.

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Name and Address	Shares Beneficially Owned	Percent of Class (1)
Emblaze Ltd.(2)	6,613,400	50.1%
Menora Mivtachim Holdings Ltd.(3)	984,111(4)	7.5%
Clal Insurance Enterprises Holdings Ltd. (5)	1,047,367(6)	7.9%

- (1) Ordinary shares deemed beneficially owned by virtue of the right of any person or group to acquire these ordinary shares within 60 days of June 20, 2008, are treated as outstanding only for the purposes of determining the percent owned by this person or group. Percentages in the above table are based on 13,200,000 ordinary shares outstanding as of June 20, 2008.
- (2) In November 2006, Emblaze Ltd., referred to as Emblaze, purchased from FIMGold LP all of its shareholdings in Formula, *i.e.* 33.4% of our outstanding share capital. Since then and until June 20, 2008, Emblaze purchased additional shares of Formula in the open market and in privately negotiated transactions, bringing its holdings in Formula to 50.1% as of June 20, 2008. Emblaze is a public company traded on the AIM. The major shareholders of Emblaze, based on publicly available and other information (*i.e.*, persons that hold 5% or more of the share capital of the Emblaze) are Naftali Shani, the chairman of the board of directors of Emblaze (who holds approximately 13.9% of the outstanding share capital of Emblaze) and Eli Reifman, vice-chairman of the board of directors of Emblaze (who holds approximately 15.4% of the outstanding share capital of Emblaze).
- (3)

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Menora Mivtachim Holdings Ltd. is a holding company publicly-traded on the TASE. 63.56% of Menora Mivtachim Holdings' outstanding shares are held, directly and indirectly, by Menachem Gurevitch, and 36.44% is held by the public.

- (4) Pursuant to Amendment No. 1 to Schedule 13D filed on February 1, 2007.
- (5) Clal Insurance Enterprises Holdings Ltd., referred to as Clal Insurance, is publicly traded on the TASE. The controlling shareholder of Clal Insurance is IDB Development Corporation Ltd. (57.4%) and Bank Hapoalim Ltd. holds a 10.1% interest in Clal Insurance.
- (6) Pursuant to Schedule 13G/A filed on February 14, 2008, of the 1,047,367 shares reported as beneficially owned by Clal Insurance (i) 1,008,067 shares are held for members of the public through, among others, provident funds, mutual funds, pension funds and insurance policies, which are managed by subsidiaries of Clal Insurance, each of which subsidiaries operates under independent management and makes independent voting and investment decisions; and (ii) 39,300 shares are beneficially held by Clal Finance Ltd. for its own account.

As of June 20, 2008, 13,200,000 ordinary shares were issued and outstanding, excluding 24,780 ordinary shares that we purchased during 2002. On June 20, 2008, we had approximately 2 shareholders of record. All of our ordinary shares have equal voting rights. However, under applicable Israeli law, the shares we hold have no voting rights and, therefore, are excluded from the number of our outstanding shares.

As of June 20, 2008, 315,542 ADSs were issued and outstanding pursuant to a depositary agreement with The Bank of New York, representing 315,542 of our ordinary shares. As of that date, there were approximately 17 registered holders of ADSs in the United States.

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B. Related Party Transactions

Indemnification of Office Holders

In December 2005, the general meeting of shareholders approved the grant of new indemnification letters to our office holders following the amendment of the Companies Law adopted in March 2005 and the changes in our articles of association approved by the general meeting in December 2005.

The indemnification letters provide, among other things, that we will indemnify each of our office holders to the maximum extent permitted by our articles of association. Advance payments for coverage of legal expenses in criminal proceedings will be required to be repaid by our office holders to the company if such office holder is found guilty of a crime which requires proof of criminal intent, or if it is determined that the office holder is not lawfully entitled to such indemnification.

All of the indemnification letters granted to our office holders are identical, including indemnification letters granted to office holders who are or may be considered controlling persons under the Companies Law.

The indemnification is limited to the expenses and matters detailed in the indemnification letters insofar as they result from the office holder's actions which includes, among other things, the following matters: the offering of securities by us to the public or to private investors, the offer by us to purchase securities from the public, private investors or other holders, whether pursuant to a prospectus, agreement, tender or any other proceeding; occurrences resulting from being a public company, or from the fact that our securities were offered to the public and traded on the NASDAQ and on the TASE, and occurrences in connection with investments.

Our undertaking for indemnification is limited to up to 25% of our shareholders' equity as it appears in our latest financial statements known at the date of indemnification.

Our undertaking for indemnification shall not apply to a liability incurred as a result of any of the following:

- (i) a breach by the office holder of his or her duty of loyalty, unless the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- (ii) a breach by the office holder of his or her duty of care if the breach was done intentionally or recklessly;

- (iii) any act or omission done with the intent to derive an illegal personal benefit; or
- (iv) any fine levied against the office holder.

We shall not be required to indemnify an office holder, if the office holder, or anyone on its behalf, already received payment in respect of a liability subject to indemnification, under an effective insurance coverage or an effective indemnification arrangement with a third party, provided, however, that if such payment made to the office holder does not cover the entire liability subject to the indemnification, we shall indemnify the office holder in respect of the difference between the amount paid to the office holder and the liability subject to the indemnification.

Office Holders Insurance

We have obtained an insurance policy covering the Formula Group's directors' and officers' liability. Our subsidiaries participate in the premium payments of the insurance, on a proportional basis. The total premium Formula paid during 2007 was approximately \$200,000.

Other Transactions

From time to time, in our ordinary course of business, we engage in transactions with our subsidiaries and affiliates. We believe that these agreements are made on an arms' length basis upon terms and conditions no less favorable to us, our subsidiaries and affiliates, as we could obtain from unaffiliated third parties. If we engage with our subsidiaries and affiliates in transactions which are not in the ordinary course of business, we receive the approvals required under the Companies Law. These approvals include audit committee approval, board approval and, in certain circumstances, shareholder approval. See Item 6.C. Board Practices.

C. Interests of Experts and Counsel

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. Consolidated Statements and Other Financial Information

Financial Statements

Our consolidated financial statements and other financial information are incorporated herein by reference to Item 18. Financial Statements below.

Legal Proceedings

We are not involved in any proceedings in which any of our directors, members of our senior management or any of our affiliates is either a party adverse to us or to our subsidiaries or has a material interest adverse to us or to our subsidiaries. We are also not involved in any legal proceedings which may have, or have had in the recent past, significant effects on our financial position or profitability.

Dividend policy

Under Formula's dividend policy adopted by its board of directors, sums that are not planned to be used for investments in the near future, will be distributed to the shareholders as a cash dividend, to the extent that our performance allows such distribution. In recent years, we have

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made the following distributions:

In April 2008, Formula distributed to its shareholders a cash dividend of approximately \$0.76 per share. The aggregate amount distributed by Formula was approximately \$10 million.

In December 2006, Formula distributed to its shareholders a dividend consisting of 36,696,000 shares of Formula Vision held by Formula and representing approximately 57% of the outstanding share capital of Formula Vision. Formula Vision shares were distributed at a ratio of 2.78 shares of Formula Vision for every one outstanding ordinary share of Formula, prior to withholding taxes.

In June 2005, Formula distributed to its shareholders a cash dividend in the amount of approximately \$4 per ordinary share, or approximately \$50.2 million in the aggregate.

B. Significant Changes

There has been no material change in our financial position since December 31, 2007.

ITEM 9. THE OFFER AND LISTING

A. Offer and Listing Details

Price Range of Ordinary Shares

The following table sets forth the high and low closing price for our ordinary shares on the TASE, for the periods indicated. The exchange rate reported by the Bank of Israel on June 20, 2008 was NIS 3.354 = \$1.00.

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Period	Closing Price Per Share	
	in NIS	
	High	Low
2003	79.40	34.03
2004	98.40	61.83
2005	89.65	46.84
2006	60.15	39.99
First Quarter	50.92	46.74
Second Quarter	60.15	46.00
Third Quarter	51.01	39.99
Fourth Quarter	59.12	40.16
2007	60.59	44.97
First Quarter	54.39	46.99
Second Quarter	60.07	52.05
Third Quarter	60.59	48.85
Fourth Quarter	57.68	44.97
December	52.83	44.97
2008		
First Quarter	47.78	37.30
January	47.78	39.28
February	45.54	43.05
March	47.74	37.30
April	48.49	41.01
May	44.00	39.18

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Period	Closing Price Per Share	
June (through June 20)	38.88	35.52

Price Range of American Depositary Shares

The following table sets forth, for the periods indicated, the high and low closing sale prices for the ADSs, as reported by the NASDAQ Global Market.

Period	Closing Price Per Share	
	High	Low
2003	18.05	6.71
2004	22.08	13.44
2005	20.44	11.00
2006	14.00	9.15
First Quarter	11.38	9.80
Second Quarter	13.50	10.00
Third Quarter	11.76	9.15
Fourth Quarter	14.00	9.40
2007	15.42	9.02
First Quarter	12.8	11.43
Second Quarter	15.27	12.69
Third Quarter	14.75	11.78
Fourth Quarter	15.42	9.02
December	13.8	9.02
2008		
First Quarter	14.14	10.9
January	12.86	10.9
February	12.85	12.00
March	14.14	11.16
April	13.32	11.92
May	13.15	12.00
June (through June 20)	11.90	10.00

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B. Plan of Distribution

Not applicable.

C. Markets

Since our initial public offering in 1991, our ordinary shares have been traded in Israel on the TASE under the symbol FORT. No U.S. trading market exists for the ordinary shares. Since October 1997, our ADSs have been traded on the NASDAQ Global Market, under the symbol FORTY.

Pursuant to NASDAQ Marketplace Rule 4350(a), we notified NASDAQ that with respect to the quorum for shareholders meetings, we follow Israeli law and practice and accordingly do not follow NASDAQ rules. The quorum for a shareholders meeting, as stipulated in our articles of association, complies with the provisions of the Israeli law, and requires the presence, in person or by proxy of holders of 25% of our

outstanding ordinary shares, in lieu of the requirement specified in NASDAQ Marketplace Rule 4350(e) pursuant to which the quorum for any shareholders meeting shall not be less than 33% of the outstanding voting shares of the company.

D. Selling Shareholders

Not applicable.

E. Dilution

Not applicable.

F. Expenses of the Issue

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. Share Capital

Not applicable.

B. Memorandum and Articles of Association

We are registered with the Israeli Companies Register under the number 52-003669-0. Our objects are specified in our memorandum of association. These objects include:

operating within the field of informational and computer systems;

providing management, consulting and sale services for computers, computer equipment, software for computers and for information systems;

the business of systems analysis, systems programming and computer programming; and

establishing facilities for instruction and training for computers and digital systems.

Description of Our Share Capital

Our company share capital consists of ordinary shares. Our articles of association do not restrict in any way the ownership of our ordinary shares by non-residents, except that these restrictions may exist with respect to citizens of countries which are in a state of war with Israel.

Dividend and Liquidation Rights

Our board of directors is authorized to declare dividends, subject to the provisions of the Companies Law. Dividends on our ordinary shares may be paid only out of profits and other surplus, as defined in the Companies Law, as of the end date of the most recent financial statements or as accrued over a period of two years, whichever is higher. Alternatively, if we do not have sufficient profits or other surplus, then permission to effect a distribution can be granted by order of an Israeli court. In any event, our board of directors is authorized to declare dividends, provided

there is no reasonable concern that the dividend will prevent us from satisfying our existing and foreseeable obligations as they become due. Dividends may be paid in cash or in kind. We may invest or use for our own benefit all unclaimed dividends. If dividends remain unclaimed for seven years from the date we declared the dividend they lapse and revert back to us. Our board of directors can cause us to pay the dividend to a holder who would have been entitled if the dividend had not reverted back to us. In case of liquidation, after satisfying liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to their holdings. This right may be affected by the grant of a preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future. Under the Companies Law, the declaration of a dividend does not require the approval of the shareholders of the company, unless the company's articles of association require otherwise. Our articles of association provide that our board of directors may declare and pay dividends without any further action of our shareholders.

Redemption Provisions

In accordance with our articles of association, we may issue redeemable shares and accordingly redeem those shares.

Voting, Shareholder Meetings and Resolutions

Holders of our ordinary shares have one vote for each ordinary share held on all matters submitted to the vote of shareholders. These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future. Under the Companies Law, shares held by the company are not entitled to any rights so long as they are held by the company.

We must hold an annual general meeting once a year with a maximum period of fifteen months between the meetings. All other meetings of shareholders other than annual general meetings are considered special general meetings. Our board of directors may call a special general meeting whenever it decides it is appropriate. In addition, shareholders representing 5% of the outstanding share capital may require the board of directors to call a special general meeting. The quorum required for a general meeting of shareholders consists of two or more holders present in person or by proxy who hold or represent at least 25% of the voting power. A meeting adjourned for a lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the chairman of the meeting may decide with the consent of the holders of a majority of the voting power represented at the meeting in person or by proxy and voting on the question of adjournment. At the reconvened meeting, if a quorum is not present within half an hour from the time appointed for holding the meeting, the required quorum will consist of two shareholders present in person or by proxy.

Under the Companies Law, unless otherwise provided in the articles of association or applicable law, all resolutions of the shareholders require a simple majority, except in certain circumstances provided for under the Israeli law, which require a majority of at least 75% of the shares present at the meeting.

Shareholder Duties

Under the Companies Law, a shareholder has a duty to act in good faith towards the company in which he holds shares and towards other shareholders and to refrain from abusing his power in the company including voting in the general meeting of shareholders on:

- any amendment to the articles of association;
- an increase of the company's authorized share capital;
- a merger; or
- approval of some of the acts and transactions which require shareholder approval.

A shareholder has the general duty to refrain from depriving rights of other shareholders. Any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, under the provisions of the articles of association, has the power to appoint an office holder in the company, is under a duty to act in fairness towards the company. The rules

pertaining to a breach of contract apply to a breach of the duty to act in fairness, mutatis mutandis, bringing into account the shareholder's position in the company. The Companies Law does not describe the substance of this duty.

Transfer of Shares

Fully paid ordinary shares are issued in registered form and may be freely transferred under our articles of association unless the transfer is restricted or prohibited by another instrument.

Modification of Class Rights

Under our articles of association, the rights attached to any class unless otherwise provided by the terms of the class including voting, rights to dividends and the like, may be varied by adoption of the necessary amendment to the articles of association, provided that the affected shareholders approve the change by a class meeting in which a simple majority of the voting power of the class represented at the meeting and voting on the matter approves the change.

Election of Directors

Our ordinary shares do not have cumulative voting rights in the election of directors. As a result, the holders of ordinary shares that represent more than 50% of the voting power represented at a shareholders meeting, have the power to elect all of our directors, other than the outside directors which are appointed by a special majority of shareholders. For a summary of those provisions in our articles of association with respect to the directors, see Item 6. Directors, Senior Management and Employees.

Anti-Takeover Provisions; Mergers and Acquisitions Under Israeli Law

Mergers

The Companies Law permits merger transactions if approved by each party's board of directors and shareholders. In determining whether the required majority has approved the merger in the event of cross ownership between the merging companies, namely, if the merging company's shares are held by the other party to the merger, or by any person holding at least 25% of the means of control of the other party to the merger, then a vote against the merger by holders of the majority of the shares present and voting, excluding shares held by the other party to the merger or by such person, or anyone acting on behalf of either of them, including any of their affiliates, is sufficient to reject the merger transaction. In the event that the merger transaction has not been approved by the special majority described above, the holders of at least 25% of the voting rights of such company may apply to the court for approval of the merger. The court may approve the merger if it is found that the merger is fair and reasonable, taking into account the value of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger. A merger may not be consummated unless at least 50 days have passed from the time that a proposal for approval of the merger has been filed with the Israeli Registrar of Companies and 30 days have passed from the date of the approval of the shareholders of the merging companies.

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The Companies Law further provides that the foregoing approval requirements will not apply to shareholders of a wholly-owned subsidiary in a rollup merger transaction, or to the shareholders of the acquirer if:

the transaction does not involve an amendment to the acquirer's memorandum or articles of association;

the transaction does not contemplate the issuance of more than 20% of the voting rights of the acquirer which would result in any shareholder becoming a controlling shareholder; and

there is no cross ownership of shares of the merging companies, as described above.

Tender Offers

The Companies Law provides that an acquisition of shares of a public company must be made by means of a tender offer if as a result of the acquisition, the purchaser would become a holder of 25% or more of the voting rights in the company. This rule does not apply if there is already another holder of 25% or more of the voting rights in the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a holder of more than

45% of the voting rights of the company, if there is no other holder of more than 45% of the voting rights of the company.

The foregoing provisions do not apply to:

a private placement in which the company's shareholders approved such holder owning 25% or more of the voting rights in the company (if there is no other shareholder that holds 25% or more of the voting rights in the company); or more than 45% of the voting rights in the company (if there is no other shareholder that holds 45% or more of the voting rights in the company); or

a purchase from an existing holder of 25% or more of the voting rights in the company that results in another person becoming a holder of 25% or more of the voting rights in the company or a purchase from an existing holder of more than 45% of the voting rights in the company that results in another person becoming a holder of more than 45% of the voting rights in the company.

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Regulations adopted under the Companies Law provide that these tender offer requirements do not apply to companies whose shares are listed for trading outside of Israel if, according to the law in the country in which the shares are traded, including the rules and regulations of the stock exchange on which the shares are traded, there is either a limitation on acquisition of any level of control of the company, or the acquisition of any level of control requires the purchaser to do so by means of a tender offer to the public.

The Companies Law also provides that if following any acquisition of shares, the acquirer holds 90% or more of the company's shares or of a class of shares, the acquisition must be made by means of a tender offer for all the target company's shares or all the shares of the class, as applicable. An acquirer who wishes to eliminate all minority shareholders must do so by way of a tender offer and acquire 95% of all shares not held by or for the benefit of the acquirer before the acquisition. If, however, the tender offer to acquire 95% is not successful, the acquirer may not acquire shares tendered if by doing so the acquirer would own more than 90% of the shares of the target company.

C. Material Contracts

We consider the sale of our shareholdings of BluePhoenix and the transactions with Formula Vision as material contracts. For more information about these transactions, see Item 4. Information on the Company History and Development Capital Expenditures and Divestitures.

D. Exchange Controls

Under current Israeli regulations, we may pay dividends or other distributions in respect of our ordinary shares either in non-Israeli or Israeli currencies. If we make these payments in Israeli currency, they will be freely transferred in non-Israeli currencies at the rate of exchange prevailing at the time of conversion. We expect therefore, that dividends, if any, that we pay to holders of ADSs, will be paid in dollars, net of conversion expenses, expenses of the depositary, the Bank of New York, and Israeli income taxes. Because exchange rates between the NIS and the dollar fluctuate continuously, a U.S. shareholder will be subject to the risk of currency fluctuations between the date when we declare NIS-denominated dividends and the date when we pay them in NIS. See Item 3. Key Information Risk Factors.

Non-residents of Israel may freely hold and trade our ADSs or ordinary shares pursuant to the general permit issued under the Israeli Currency Control Law, 1978. Neither our articles of association nor the laws of the State of Israel restrict in any way the ownership of our ordinary shares by non-residents, except that these restrictions may exist with respect to citizens of countries which are in a state of war with Israel.

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E. Taxation

Israeli Taxation

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The following is a description of material tax consequences regarding the ownership and disposition of our ordinary shares and ADSs under Israeli tax laws to which U.S. and other non-Israeli shareholders may be subject. The information below does not apply to specified persons or cover specified situations. Therefore, you are advised to consult your own tax advisor as to particular tax consequences unique to you related to an investment in our ordinary shares or ADSs, including the effects of applicable Israeli or foreign or other tax laws and possible changes in the tax laws.

To the extent that the discussion is based on legislation yet to be judicially or administratively interpreted, we cannot assure you that the views we express herein will accord with any such interpretation in the future.

Tax Consequences Regarding Disposition of Our ADSs or Ordinary Shares

In general, Israel imposes capital gains tax on the sale of capital assets, including shares of Israeli companies by both Israeli residents and non-Israeli resident shareholders, unless a specific exemption is available or unless a tax treaty between Israel and the shareholders' country of residence provide otherwise. Shareholders that are not Israeli residents are generally exempt from Israeli capital gains tax on any gain derived from the sale of our ADSs or ordinary shares, provided that (i) such shareholders did not acquire the shares prior to our initial public offering; and (ii) such gains did not derive from a permanent establishment of such shareholders in Israel. However, non-Israeli corporations will not be entitled to the foregoing exemption if an Israeli resident (a) has a controlling interest of 25% or more in such non-Israeli corporation; or (b) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In certain instances where our non-Israeli shareholders may be liable to Israeli tax on the sale of our ADSs or ordinary shares, the payment of the consideration may be subject to Israeli withholding tax.

In addition, in the case when the sale, exchange or disposition of our ADSs or ordinary shares by shareholders who are U.S. residents (within the meaning of the U.S.-Israel Tax Treaty) holding the ADSs or ordinary shares as a capital asset will be also exempt from Israeli capital gains tax under the U.S.-Israel Tax Treaty, unless, either (i) the shareholders hold, directly or indirectly, shares representing 10% or more of our voting shares during any part of the 12-month period preceding such sale, exchange or disposition; or (ii) the capital gains arising from such sale, exchange or disposition are attributable to a permanent establishment of the shareholders located in Israel. In such case, the shareholders would be subject to Israeli capital gains tax, to the extent applicable, as mentioned above. However, under the U.S.-Israel Tax Treaty, the U.S. resident would be permitted to claim a credit for such taxes against the U.S. federal income tax imposed on the sale, exchange or disposition, subject to the limitation in the U.S. law applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

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Taxes Applicable to Dividends

Nonresidents of Israel are generally subject to Israeli income tax on the receipt of dividends paid on our ADSs or ordinary shares at the rate of 20%, or 15% for dividends or income generated by an approved enterprise, which tax will be withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence.

However, the tax rate on dividends paid to a substantial shareholder (which is someone who alone, or together with another person, holds, directly or indirectly, at least 10% in one or all of any of the means of control in the corporation) is 25%.

Under Israeli tax law, a distribution of dividends from income attributable to an Approved Enterprise will be subject to tax in Israel at the rate of 15%, which is withheld and paid by the company paying the dividend, if the dividend is distributed during the benefits period or within the following 12 years (but the 12-year limitation does not apply to a Foreign Investors Company). Any distribution of dividends from income that is not attributable to an Approved Enterprise after January 1, 2006, will be subject to tax in Israel at the rate of 20%.

Under the U.S.-Israel Tax Treaty, the maximum rate of tax withheld in Israel on dividends paid to a holder of our ADSs or ordinary shares who is a U.S. resident (within the meaning of the U.S.-Israel Tax Treaty) is 25%. However, dividends paid from income derived from our Approved Enterprise are subject to withholding at the rate of 15%, although we cannot assure you that we will designate the profits that are being distributed in a way that will reduce shareholders' tax liability according to the U.S.-Israel Tax Treaty. Furthermore, the maximum rate of withholding tax on dividends not generated by our Approved Enterprise, that are paid to a U.S. corporation holding 10% or more of our outstanding voting capital during the part of the tax year that precedes the date of the payment of the dividend and during the whole of its prior tax year, is 12.5%. This reduced rate will not apply if more than 25% of our gross income consists of interest or dividends, other than dividends or interest received from a subsidiary corporation, 50% or more of the outstanding voting shares of which are owned by the company.

A nonresident of Israel who receives dividends with respect of which tax was fully paid, is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer and the taxpayer has no other taxable sources of income in Israel.

United States Federal Income Tax Considerations

Subject to the limitations described herein, this discussion summarizes certain United States federal income tax consequences of the purchase, ownership and disposition of our ordinary shares or ADSs to a United States holder. A United States holder is a holder of our ordinary shares or ADSs who is:

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an individual who is a citizen or resident of the United States for United States federal income tax purposes;

a corporation (or another entity taxable as a corporation for United States federal income tax purposes) created or organized under the laws of the United States, any political subdivision thereof, or the District of Columbia;

an estate, the income of which is subject to United States federal income tax regardless of its source; or

a trust (i) if, in general, a United States court is able to exercise primary supervision over its administration and one or more United States persons have the authority to control all of its substantial decisions or (ii) that has in effect a valid election under applicable United States Treasury Regulations to be treated as a United States person.

Unless otherwise specifically indicated, this discussion does not consider the United States tax consequences to a person that is not a United States holder (a non-United States holder) and considers only United States holders that will own the ordinary shares or ADSs as capital assets (generally, for investment).

This discussion is based on current provisions of the Internal Revenue Code of 1986, as amended (the Code), current and proposed Treasury Regulations promulgated under the Code and administrative and judicial interpretations of the Code, all as currently in effect and all of which are subject to change, possibly with retroactive effect. This discussion does not address all aspects of United States federal income taxation that may be relevant to any particular United States holder based on the United States holder's individual circumstances. In particular, this discussion does not address the United States federal income tax consequences to United States holders who are broker-dealers or who own, directly, indirectly or constructively, 10% or more of our outstanding voting shares, United States holders holding the ordinary shares or ADSs as part of a hedging, straddle or conversion transaction, United States holders whose functional currency is not the United States dollar, insurance companies, tax-exempt organizations, financial institutions, financial service entities, persons who acquired their shares upon the exercise of employee stock options or otherwise as compensation, real estate investment trusts, regulated investment companies, grantor trusts, individual retirement and tax-deferred accounts, certain former citizens or long-term residents of the United States and persons subject to the alternative minimum tax, who may be subject to special rules not discussed below. Additionally, the tax treatment of persons who are, or hold the ordinary shares or ADSs through, a partnership or other pass-through entity is not considered, nor is the possible application of United States federal estate or gift taxes or any aspect of state, local or non-United States laws.

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You are advised to consult your tax advisor with respect to the specific United States federal, state, local and foreign tax consequences to you of purchasing, holding or disposing of our ordinary shares or ADSs.

Taxation of Distributions on the Ordinary Shares or ADSs

Subject to the discussion below under Tax Consequences if We Are a Passive Foreign Investment Company, a distribution paid by us with respect to the ordinary shares or ADSs to a United States holder will be treated as dividend income to the extent that the distribution does not exceed our current and accumulated earnings and profits, as determined for United States federal income tax purposes. The amount of the distribution with respect to the ordinary shares or ADSs will equal the amount of cash and the fair market value of any property distributed and will also include the amount of any non-U.S. taxes withheld from such distribution. Dividends that are received by United States holders that are individuals, estates or trusts will be taxed at the rate applicable to long-term capital gains (a maximum rate of 15% through taxable years beginning on or before December 31, 2010), provided that such dividends meet the requirements of qualified dividend income. For this purpose,

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qualified dividend income generally includes dividends paid by a non-U.S. corporation if certain holding period and other requirements are met and either (a) the stock of the non-U.S. corporation with respect to which the dividends are paid is readily tradable on an established securities market in the United States (e.g., the NASDAQ Global Market) or (b) the non-U.S. corporation is eligible for benefits of a comprehensive income tax treaty with the United States which includes an information exchange program and is determined to be satisfactory by the United States Secretary of the Treasury. The United States Internal Revenue Service (IRS) has determined that the United States-Israel income tax treaty is satisfactory for this purpose. Dividends that fail to meet such requirements, and dividends received by corporate United States holders, are taxed at ordinary income rates. No dividend received by a United States holder will be a qualified dividend (1) if the United States holder held the ordinary share or ADS with respect to which the dividend was paid for less than 61 days during the 121-day period beginning on the date that is 60 days before the ex-dividend date with respect to such dividend, excluding for this purpose, under the rules of Code Section 246(c), any period during which the United States holder has an option to sell, is under a contractual obligation to sell, has made (and not closed) a short sale of, is the grantor of a deep-in-the-money or otherwise nonqualified option to buy, or has otherwise diminished its risk of loss by holding other positions with respect to, such ordinary share or ADS (or substantially identical securities); or (2) to the extent that the United States holder is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in property substantially similar or related to the ordinary share or ADS with respect to which the dividend is paid. If we were to be a passive foreign investment company (as such term is defined in the Code), or PFIC , for any taxable year, dividends paid on our ordinary shares or ADSs in such year or in the following taxable year would not be qualified dividends. See the discussion below regarding our PFIC status under Tax Consequences if We Are a Passive Foreign Investment Company. In addition, a non-corporate United States holder will be able to take a qualified dividend into account in determining its deductible investment interest (which is generally limited to its net investment income) only if it elects to do so; in such case the dividend income will be taxed at ordinary income rates.

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The amount of any distribution which exceeds the amount treated as a dividend will be treated first as a non-taxable return of capital, reducing the United States holder's tax basis in its ordinary shares or ADSs to the extent thereof, and then as capital gain from the deemed disposition of the ordinary shares or ADSs. Corporate holders will not be allowed a deduction for dividends received in respect of the ordinary shares or ADSs.

Dividends paid by us in NIS generally will be included in the income of United States holders at the dollar amount of the dividend (including any Israeli taxes withheld therefrom), based upon the spot rate of exchange in effect on the date the distribution is received. United States holders will have a tax basis in NIS for United States federal income tax purposes equal to that dollar value. A United States holder that converts a dividend paid in NIS into United States dollars subsequent to receipt will have foreign exchange gain or loss arising from exchange rate fluctuations, which will generally be taxable as United States source ordinary income or loss.

Subject to the limitations set forth in the Code and the Treasury Regulations thereunder, United States holders may elect to claim as a foreign tax credit against their United States federal income tax liability, the non-U.S. income tax withheld from dividends received in respect of the ordinary shares or ADSs. The limitations on claiming a foreign tax credit include, among others, computation rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the United States federal income taxes otherwise payable with respect to each such class of income. In this regard, dividends paid by us generally will be foreign source passive income for U.S. foreign tax credit purposes, or, in the case of a financial services entity, financial services income (and for the tax years beginning after December 31, 2006 as general category income). United States holders that do not elect to claim a foreign tax credit may instead claim a deduction for the non-U.S. income tax withheld if they itemize deductions. The rules relating to foreign tax credits are complex, and you should consult your tax advisor to determine whether and to what extent you would be entitled to this credit. A United States holder will be denied a foreign tax credit for non-U.S. income tax withheld from a dividend received on the ordinary shares or ADSs (i) if the United States holder has not held the ordinary shares or ADSs for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date with respect to such dividend or (ii) to the extent the United States holder is under an obligation to make related payments with respect to positions in substantially similar or related property. Any days during which a United States holder has substantially diminished its risk of loss on the ordinary shares or ADSs are not counted toward meeting the required 16-day holding period. Distribution of current or accumulated earnings and profits generally will be foreign source passive income for United States foreign tax credit purposes.

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Taxation of the Disposition of the Ordinary Shares or ADSs

Subject to the discussion below under Tax Consequences if We Are a Passive Foreign Investment Company, upon the sale, exchange or other disposition of our ordinary shares or ADSs, a United States holder will recognize capital gain or loss in an amount equal to the difference between the amount realized on the disposition and the United States holder's tax basis in the ordinary shares or ADSs. The gain or loss recognized on the disposition will be long-term capital gain or loss if the United States holder held the ordinary shares or ADSs for more than

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one year at the time of the disposition and non-corporate United States holders may be eligible for a reduced rate of taxation (currently a maximum rate of 15% for taxable years beginning on or before December 31, 2010). Capital gain from the sale, exchange or other disposition of ordinary shares or ADSs held for one year or less is short-term capital gain and taxed as ordinary income. Gain or loss recognized by a United States holder on a sale, exchange or other disposition of ordinary shares or ADSs generally will be treated as U.S. source income or loss for United States foreign tax credit purposes. The deductibility of capital losses is subject to certain limitations.

A United States holder that uses the cash method of accounting calculates the dollar value of the proceeds received on the sale as of the date that the sale settles. However, a United States holder that uses the accrual method of accounting is required to calculate the value of the proceeds of the sale as of the trade date and may therefore realize foreign currency gain or loss. A United States holder that uses the accrual method may avoid realizing foreign currency gain or loss by electing to use the settlement date to determine the proceeds of sale for purposes of calculating the foreign currency gain or loss. In addition, a United States holder that receives foreign currency upon disposition of ordinary shares or ADSs and converts the foreign currency into dollars after the settlement date or trade date (whichever date the United States holder is required to use to calculate the value of the proceeds of sale) may have foreign exchange gain or loss based on any appreciation or depreciation in the value of the foreign currency against the dollar, which will generally be United States source ordinary income or loss.

Tax Consequences if We Are a Passive Foreign Investment Company

We will be a passive foreign investment company, or PFIC, for a taxable year if either (1) 75% or more of our gross income in the taxable year is passive income; or (2) the average percentage (by value) in a taxable year of our assets that produce, or are held for the production of, passive income is at least 50%. If we own (directly or indirectly) at least 25% by value of the stock of another corporation, we will be treated for purposes of the foregoing tests as owning our proportionate share of the other corporation's assets and as directly earning our proportionate share of the other corporation's income. If we are a PFIC, a United States holder must determine under which of three alternative taxing regimes it wishes to be taxed:

The QEF regime applies if the United States holder elects to treat us as a qualified electing fund (QEF) for the first taxable year in which the United States holder owns our ordinary shares or ADSs or in which we are a PFIC, whichever is later, and if we comply with certain reporting requirements. If the QEF regime applies, then each year that we are a PFIC such United States holder will include in its gross income a proportionate share of our ordinary earnings (which is taxed as ordinary income) and net capital gain (which is taxed as long-term capital gain), subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge. These amounts would be included in income by an electing United States holder for its taxable year in which our taxable year ends, whether or not such amounts are actually distributed to the United States holder. A United States holder's basis in our ordinary shares or ADSs for which a QEF election has been made would be increased to reflect the amount of any taxed but undistributed income. Generally, a QEF election allows an electing United States holder to treat any gain realized on the disposition of his ordinary shares or ADSs as capital gain.

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Once made, the QEF election applies to all subsequent taxable years of the United States holder in which it holds our ordinary shares or ADSs and for which we are a PFIC, and can be revoked only with the consent of the IRS. The QEF election is made by attaching a completed IRS Form 8621, including the PFIC annual information statement, to a timely filed United States federal income tax return. Even if a QEF election is not made, a U.S. person who is a shareholder in a PFIC must file a completed IRS Form 8621 every year.

If a QEF election is made after the first taxable year in which a United States holder holds our ordinary shares or ADSs and we are a PFIC, then special rules would apply.

A second regime, the mark-to-market regime, may be elected so long as our ordinary shares or ADSs are marketable stock (e.g., regularly traded on the NASDAQ Global Market). Pursuant to this regime, an electing United States holder's ordinary shares or ADSs are marked-to-market for each year that we are a PFIC and the United States holder recognizes as ordinary income or loss an amount equal to the difference as of the close of the taxable year between the fair market value of our ordinary shares or ADSs and the United States holder's adjusted tax basis therein. Losses are allowed only to the extent of net mark-to-market gain previously included by the United States holder under the election for prior taxable years. An electing United States holder's adjusted basis in our ordinary shares or ADSs is increased by income recognized under the mark-to-market election and decreased by the deductions allowed under the election.

Under the mark-to-market election, gain on the sale of our ordinary shares or ADSs is treated as ordinary income, and loss on the sale of our ordinary shares or ADSs, to the extent the amount of loss does not exceed the net mark-to-market gain previously

included, is treated as ordinary loss (losses in excess of net mark-to-market gain previously included are generally capital losses). The mark-to-market election applies to the tax year for which the election is made and all later tax years, unless the ordinary shares or ADSs cease to be marketable or the IRS consents to the revocation of the election.

If the mark-to-market election is made after the first taxable year in which a United States holder holds our ordinary shares or ADSs and we are a PFIC, then special rules would apply.

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A United States holder making neither the QEF election nor the mark-to-market election is subject to the excess distribution regime. Under this regime, excess distributions are subject to special tax rules. An excess distribution is either (1) a distribution with respect to ordinary shares or ADSs that is greater than 125% of the average distributions received by the United States holder from us over the shorter of either the preceding three years or such United States holder's holding period for our ordinary shares or ADSs, or (2) gain from the disposition of our ordinary shares or ADSs (including gain deemed recognized if the ordinary shares or ADSs are used as security for a loan).

Excess distributions must be allocated ratably to each day that a United States holder has held our ordinary shares or ADSs. A United States holder must include amounts allocated to the current taxable year and to any period prior to the first day of the first taxable year for which we are a PFIC in its gross income as ordinary income for the current taxable year. All amounts allocated to other years of the United States holder would be taxed at the highest tax rate for each such prior year applicable to ordinary income. The United States holder also would be liable for interest on the deferred tax liability for each such other year calculated as if such liability had been due with respect to each such other year. A United States person who inherits shares or ADSs in a non-U.S. corporation that was a PFIC in the hands of the decedent is generally denied the otherwise available step-up in the tax basis of such shares or ADSs to fair market value at the date of death.

We believe that in 2007 we were not a PFIC and currently we expect that we will not be a PFIC in 2008. However, PFIC status is determined as of the end of the taxable year and is dependent on a number of factors, including the value of our assets and the amount and type of our gross income. Therefore, there can be no assurance that we will not become a PFIC for the current taxable year ending December 31, 2008 or in a future year. We will notify United States holders in the event we conclude that we will be treated as a PFIC for any taxable year to enable United States holders to consider whether or not to elect to treat us as a QEF for United States federal income tax purposes or to mark-to-market the ordinary shares or ADSs or to become subject to the excess distribution regime.

United States holders are urged to consult their tax advisors regarding the application of the PFIC rules, including eligibility for and the manner and advisability of making, the QEF election or the mark-to-market election.

Information Reporting and Backup Withholding

A United States holder generally is subject to information reporting and may be subject to backup withholding (currently at rate of up to 28% through 2010) with respect to dividend payments on, or receipt of the proceeds from the disposition of, the ordinary shares or ADSs. Backup withholding will not apply with respect to payments made to exempt recipients, including corporations and tax-exempt organizations, or if a United States holder provides a correct taxpayer identification number, certifies that such holder is not subject to backup withholding or otherwise establishes an exemption. Backup withholding is not an additional tax and may be claimed as a credit against the United States federal income tax liability of a United States holder, or alternatively, the United States holder may be eligible for a refund of any excess amounts withheld under the backup withholding rules, in either case, provided that the required information is furnished to the IRS.

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Non-United States holders of Ordinary Shares or ADSs

Except as provided below, a non-United States holder of ordinary shares or ADSs will not be subject to United States federal income or withholding tax on the receipt of dividends on, and the proceeds from the disposition of, an ordinary share or ADS, unless, in the case of United States federal income taxes, that item is effectively connected with the conduct by the non-United States holder of a trade or business in the United States and, in the case of a resident of a country which has an income tax treaty with the United States, that item is attributable to a permanent establishment in the United States or, in the case of an individual, a fixed place of business in the United States. In addition, gain

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recognized by an individual non-United States holder upon the disposition of our ordinary shares or ADSs will be subject to tax in the United States if the non-United States holder is present in the United States for 183 days or more in the taxable year of the sale and certain other conditions are met.

Non-United States holders generally will not be subject to information reporting or backup withholding with respect to the payment of dividends on, or the proceeds from the disposition of, ordinary shares or ADSs, provided that the non-United States holder provides its taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption.

F. Dividends and Paying Agents

Not applicable.

G. Statement by Experts

Not applicable.

H. Documents on Display

Formula is subject to the reporting requirements of the Exchange Act that are applicable to a foreign private issuer. In accordance with the Exchange Act, we file with the SEC reports, including annual reports on Form 20-F by June 30 each year. In addition, we furnish interim financial information on Form 6-K on a quarterly basis. We also furnish to the SEC under cover of Form 6-K certain other material information required to be made public in Israel, filed with and made public by any stock exchange or distributed by us to our shareholders. You may inspect without charge and copy at prescribed rates such material at the public reference facilities maintained by the SEC, at 100 F Street, N.E., Washington, D.C. 20549. You may also obtain copies of such material from the SEC at prescribed rates by writing to the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room.

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The SEC maintains an Internet site at <http://www.sec.gov> that contains reports and other material that are filed through the SEC's Electronic Data Gathering, Analysis and Retrieval (EDGAR) system. Formula began filing through the EDGAR system beginning in October 2002.

Formula's ADSs are quoted on the NASDAQ Global Market. You may inspect reports and other information concerning Formula at the offices of the National Association of Securities Dealers, Inc., 9513 Key West Avenue, Rockville, Maryland 20850. You may also find our reports filed with the ISA on the Magna site whose address is <http://www.magna.isa.gov.il>.

Our Internet address is <http://www.formulasystems.com>. A copy of each report submitted in accordance with applicable United States law is available for public review at our principal executive offices.

I. Subsidiary Information

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Currency Exchange Rate Fluctuations and Impact of Inflation

In light of the nature of our activities, we invest our cash and cash equivalents primarily in short-term deposits. As of December 31, 2007, we invested substantially all of the cash we held in dollar accounts bearing interest based on LIBOR, euro accounts and NIS accounts bearing interest based on the Israeli prime rate.

An increase in value of the NIS against the dollar or euro may have a negative impact on our operating results and financial condition. Depending upon the circumstances, we will consider entering into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar or euro against the NIS. There can be no assurance that these activities, or others that we may use from time to time, will eliminate the negative financial impact of currency fluctuations and inflation.

We do not engage in currency speculation. Generally, we do not hold nor have we issued, to any material extent, any derivatives or other financial instruments for trading purposes.

Fluctuations in Market Price of Securities We Hold

We hold securities of several publicly traded companies on the NASDAQ Global Market and the TASE. These companies include Magic, Matrix and Sapiens. We consider these holdings as long-term holdings. We are exposed to the risk of fluctuation of the price of these companies securities. All of these publicly traded companies have experienced significant historical volatility in their stock prices. Fluctuations in the market price of our holdings in these companies may result in the fluctuation of the value of our assets. We typically do not attempt to reduce or eliminate our market exposure on these securities.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

ITEM 15. CONTROLS AND PROCEDURES

(a) *Disclosure Controls and Procedures.* Formula's management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of Formula's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of December 31, 2007. Based on this evaluation, our chief executive officer and chief financial officer have concluded that, as of such date, Formula's disclosure controls and procedures were (i) designed to ensure that material information relating to Formula, including its consolidated subsidiaries, is made known to our management, including our chief executive officer and chief financial officer, by others within those entities, as appropriate to allow timely decisions regarding required disclosure, particularly during the period in which this report was being prepared; and (ii) effective, in that they provide reasonable assurance that information required to be disclosed by Formula in the reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) *Management's Annual Report on Internal Control over Financial Reporting.* Our board of directors and audit committee are responsible for establishing and maintaining adequate internal control over financial reporting. Formula's internal control system was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation and fair presentation of our consolidated financial statements.

Our chief executive officer and chief financial officer assessed the effectiveness of Formula's internal control over financial reporting as of December 31, 2007. In making this assessment, they used the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, our chief executive officer and chief financial officer have concluded that, as of December 31, 2007, Formula's internal control over financial reporting is effective based on those criteria.

Notwithstanding the foregoing, all internal control systems no matter how well designed have inherent limitations. Therefore, even those systems determined to be effective may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

(c) *Attestation Report of the Registered Public Accounting Firm.* This annual report includes an attestation report of our registered public accounting assessing our internal control over financial reporting.

(d) *Changes in Internal Control Over Financial Reporting.* During the period covered by this report, there were no changes in Formula's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, Formula's internal control over financial reporting.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that Shlomo Nass, a member of our audit committee and an independent member of our board of directors pursuant to the NASDAQ requirements, is an audit committee financial expert, as defined by applicable SEC regulations.

ITEM 16B. CODE OF ETHICS

Formula has adopted a code of business conduct and ethics applicable to its executive officers, directors and all other employees. A copy of the code is available to all Formula's employees, investors and others upon request to the following address: Formula Systems (1985) Ltd., 3 Abba Eban Boulevard, Herzliya 46725, Israel, Attn: Chief Financial Officer. Any waiver of this code for executive officers or directors will be disclosed through the filing of a Form 6-K.

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ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Policy on Pre-Approval of Audit and Non-Audit Services of Independent Auditors

Our audit committee is responsible for the oversight of our independent auditor's work. The audit committee's policy is to pre-approve all audit and non-audit services provided by Ziv Haft independent registered public accounting firm, BDO member firm. These services may include audit services, audit-related services, tax services and other services, as further described below. The audit committee sets forth the basis for its pre-approval in detail, listing the particular services or categories of services which are pre-approved, and setting forth a specific budget for such services. Additional services may be pre-approved by the audit committee on an individual basis. Once services have been pre-approved, Ziv Haft independent registered public accounting firm, BDO member firm and our management then report to the audit committee on a periodic basis regarding the extent of services actually provided in accordance with the applicable pre-approval, and regarding the fees for the services performed.

Principal Accountant Fees and Services

We paid the following fees for professional services rendered by Ziv Haft independent registered public accounting firm, BDO member firm, for the years ended December 31:

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

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	2007	2006
	(\$ in thousands)	
Audit Fees	617	1,080
Audit-Related Fees	150	--
Tax Fees	96	135
All Other Fees	--	86
Total	863	1,301

The Audit Fees for the years ended December 31, 2007 and 2006 were for professional services rendered for the audits of our annual consolidated financial statements, review of our consolidated quarterly financial statements, statutory audits of Formula and certain subsidiaries, issuance of comfort letters, consents and assistance with review of documents filed with the SEC.

The audit-related fees for the year ended December 31, 2007 were primarily related to internal control review.

Tax Fees for the years ended December 31, 2007 and 2006 were for services related to tax compliance, including the preparation of tax returns and claims for refund, and tax advice.

All other Fees for the year ended December 31, 2006 were primarily for due diligence related to acquisitions of certain subsidiaries

The amounts in 2006 include amounts that were paid by our former subsidiaries, Formula Vision and BluePhoenix.

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ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Not applicable.

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P A R T III

ITEM 17. FINANCIAL STATEMENTS

We have responded to Item 18 in lieu of this item.

ITEM 18. FINANCIAL STATEMENTS

Our consolidated financial statements and the report of independent registered public accounting firm in connection therewith are filed as part of this annual report, as noted on the pages below:

ITEM 18. FINANCIAL STATEMENTS

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Consolidated Balance Sheets at December 31, 2007 and 2006	F-5
Consolidated Statements of Operations for the Years Ended December 31, 2007, 2006 and 2005	F-7
Consolidated Statements of Changes in Shareholders' Equity for the Years Ended December 31, 2007, 2006 and 2005	F-8
Consolidated Statements of Cash Flows for the Years Ended December 31, 2007, 2006 and 2005	F-9
Notes to Consolidated Financial Statements	F-14

ITEM 19. EXHIBITS

Exhibit No.

1.1	Memorandum of Association (1)
1.2	Articles of Association as amended on December 28, 2005 (2)
4.1	Form of Letter of Indemnification, dated December 28, 2005 (2)
4.2	International Securities Purchase Agreement dated June 15, 2007 between the Registrant and each of the purchasers identified on the signature pages of the agreement (3)

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Exhibit No.

8	List of Subsidiaries
12.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
12.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
13.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
13.2	Certification of the Chief Financial Officer pursuant to Section. 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the Registration Statement on Form F-1 (File No. 333-8858).

(2) Incorporated by reference to the Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 29, 2006.

(3) Incorporated by reference to the Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 29, 2007.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli corporation)

2007 Annual Report

FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

2007 CONSOLIDATED FINANCIAL STATEMENTS

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The amounts are stated in U.S. dollars (\$).

ZIV HAFT
Certified Public Accountants (Isr.)

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E-mail: zivhaft@bdo.co.il www.bdo.co.il

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of

FORMULA SYSTEMS (1985) LTD.

We have audited the accompanying consolidated balance sheets of Formula Systems (1985) Ltd. and its subsidiaries (the Company) as of December 31, 2007 and 2006 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2007. 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, whose consolidated assets constitute approximately 22% and 19% of total consolidated assets as of December 31, 2007 and 2006, respectively, and whose consolidated revenues constitute approximately 20%, 23% and 24% of total consolidated revenues for the years ended December 31, 2007, 2006 and 2005, respectively. The financial statements of those subsidiaries were audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included in respect of those subsidiaries is based solely on the reports of the other auditors.

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

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presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2007 and 2006, and the related consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated June 30, 2008 expressed an unqualified opinion thereon.

Haifa Tel: 04-8680600, Fax: 04-8620866
Jerusalem Tel: 02-6546200, Fax: 02-6526633

Kiryat Shmona Tel: 04-6951389, Fax: 04-6951360
Beer Sheva Tel: 08-6654432, Fax: 08-6270008

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As discussed in Note 1R to the consolidated financial statements, in 2007 the Company adopted FASB interpretation No. 48 Accounting for Uncertainty in Income Taxes - An Interpretation of FASB No. 109, effective January 1, 2007.

Tel Aviv, Israel
June 30, 2008

Ziv Haft
Certified Public Accountants (Isr.)
BDO Member Firm

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ZIV HAFT
Certified Public Accountants (Isr.)

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Tel: +972 3 638 6868, Fax: +972 3 639 4320
E-mail: zivhaft@bdo.co.il www.bdo.co.il

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of

FORMULA SYSTEMS (1985) LTD.

We have audited Formula Systems (1985) Ltd. (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 15b Management Report Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). These standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was

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maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

Haifa Tel: 04-8680600, Fax: 04-8620866
Jerusalem Tel: 02-6546200, Fax: 02-6526633

Kiryat Shmona Tel: 04-6951389, Fax: 04-6951360
Beer Sheva Tel: 08-6654432, Fax: 08-6270008

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

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

In our opinion, the Company maintained in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company and subsidiaries as of December 31, 2006 and 2007, 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, 2007 and our report dated June 30, 2008 expressed an unqualified opinion thereon.

Tel Aviv, Israel
June, 30 2008

Ziv Haft
Certified Public Accountants (Isr.)
BDO Member Firm

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	161,504	103,548
Short-term investments (Note 3)	40,276	15,031
Trade receivables (net of allowances for doubtful debts of \$4,678 and \$4,135 as of December 31, 2007 and 2006, respectively)	139,478	119,504
Other current assets (Note 15A)	34,822	17,582
Inventories	3,157	2,753
	<u>379,237</u>	<u>258,418</u>
LONG-TERM INVESTMENTS, LOANS AND RECEIVABLES:		
Loans and other investments (Note 4)	14,849	3,861
Investments in affiliates (Note 5)	3,792	720
	<u>18,641</u>	<u>4,581</u>
SEVERANCE PAY FUND	<u>36,851</u>	<u>29,961</u>
PROPERTY AND EQUIPMENT, NET (Note 6)	<u>15,794</u>	<u>15,921</u>
GOODWILL (Note 1J and Note 7)	<u>119,014</u>	<u>104,273</u>
OTHER ASSETS, NET (Note 8)	<u>43,046</u>	<u>37,950</u>
TOTAL ASSETS ATTRIBUTED TO DISCONTINUED OPERATIONS (Note 16)	<u>41</u>	<u>146,383</u>
	<u>612,624</u>	<u>597,487</u>

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(An Israeli Corporation)

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Liabilities to banks and others (Notes 9B and 15B)	26,954	40,414
Trade payables	57,099	49,719
Other accounts payable (Note 15C)	73,072	56,967
Debentures (Note 10)	3,524	4,450
	<u>160,649</u>	<u>151,550</u>
LONG-TERM LIABILITIES:		
Debentures (Note 10)	71,880	11,796
Deferred taxes	3,276	457
Customer advances	2,181	449
Liabilities to banks and others (Note 9)	23,685	59,268
Liability in respect of the acquisition of activities	1,373	1,489
Accrued severance pay	42,774	35,340
	<u>145,169</u>	<u>108,799</u>
TOTAL LIABILITIES ATTRIBUTED TO DISCONTINUED OPERATIONS (Note 16)	<u>503</u>	<u>98,782</u>
MINORITY INTEREST	<u>107,915</u>	<u>85,066</u>
COMMITMENTS AND CONTINGENCIES (Note 12)		
SHAREHOLDERS EQUITY (Note 13):		
Share capital - ordinary shares of NIS 1 par value (authorized - December 31, 2007 and 2006 - 25,000,000 shares; issued: December 31, 2007 - 13,224,780 and 2006 - 13,224,780 shares)	3,736	3,736
Additional paid-in capital	132,545	132,545
Retained earnings	69,229	32,165
Other accumulated comprehensive loss	(6,863)	(14,897)

	198,647	153,549
Cost of 24,780 treasury shares	(259)	(259)
TOTAL SHAREHOLDERS EQUITY	198,388	153,290
	612,624	597,487

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2007	2006	2005
(U.S. \$ in thousands, except per share amounts)			
Revenues (Note 15I(2))			
Proprietary software products	100,823	96,868	90,940
Software services	392,527	319,939	274,901
Total revenues	493,350	416,807	365,841
Cost of revenues			
Proprietary software products	52,923	53,820	47,674
Software services	316,187	255,627	218,560
Total cost of revenues	369,110	309,447	266,234
Gross profit	124,240	107,360	99,607
Research and development costs, net	6,547	5,508	6,094
Selling, general and administrative expenses	90,458	88,844	86,682
Restructuring and non-recurring costs (Note 15D)	-	2,911	1,455
Operating income	27,235	10,097	5,376
Financial expenses, net (Note 15E)	(3,810)	(4,660)	(2,059)
Gain on realization of shareholdings, net (Note 15G)	2,039	3,724	3,192

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Other expenses (Note 15F)	(750)	(1,102)	(341)
Income before taxes on income	24,714	8,059	6,168
Taxes on income (Note 14)	(1,933)	(3,766)	(4,647)
	22,781	4,293	1,521
Equity in gains (losses) of affiliated companies, net	(653)	47	62
Minority interest in earnings of subsidiaries, net	(9,667)	(4,832)	189
Income (loss) from continuing operation	12,461	(492)	1,772
Income (loss) from discontinued operation, net (Note 16)	24,798	10,507	(1,589)
Net income	37,259	10,015	183

Earnings (losses) per share generated from continuing operation:

Basic	0.95	(0.04)	0.14
Diluted	0.93	(0.04)	0.14

Earnings (losses) per share generated from discontinued operation:

Basic	1.87	0.84	(0.13)
Diluted	1.86	0.77	(0.13)

Total earnings per share:

Basic	2.82	0.8	0.01
Diluted	2.79	0.73	0.01

Weighted average number of shares outstanding in thousands (Note 15J):

Basic	13,200	13,200	12,800
Diluted	13,200	13,298	12,800

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

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

<u>Share Capital</u>	Additional paid-in	Retained Earnings	Accumulated other comprehensive loss	Cost of Treasury	Total
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	Number of Shares	Amount	Capital			Shares	
(U.S. \$ in thousands)							
Balance as of January 1, 2005	10,800,000	3,215	99,535	99,166	(14,879)	(259)	186,778
Changes during 2005:							
Net Income	-	-	-	183	-	-	183
Unrealized gains from available-for-sale securities, net	-	-	-	-	(56)	-	(56)
Currency translation adjustments	-	-	-	-	(6,770)	-	(6,770)
Total comprehensive income	-	-	-	-	-	-	(6,643)
Issuance of shares, net*	2,400,000	521	32,786	-	-	-	33,307
Dividend distribution	-	-	-	(50,185)	-	-	(50,185)
Beneficial conversion features	-	-	181	-	-	-	181
Capital fund arising from elimination of gain on realization of development stage entity	-	-	7	-	-	-	7
Balance as of December 31, 2005	13,200,000	3,736	132,509	49,164	(21,705)	(259)	163,445
Changes during 2006:							
Net Income	-	-	-	10,015	-	-	10,015
Unrealized loss from available-for-sale securities, net	-	-	-	-	376	-	376
Currency translation adjustments	-	-	-	-	6,433	-	6,433
Total comprehensive income	-	-	-	-	-	-	16,824
Employee stock options exercised	-	-	36	-	-	-	36
Spin off	-	-	-	(27,015)	-	-	(27,015)
Balance as of December 31, 2006	13,200,000	3,736	132,545	32,164	(14,896)	(259)	153,290
Changes during 2007:							
Net Income	-	-	-	37,259	-	-	37,259
Unrealized gain from available - for-sale securities, net	-	-	-	-	(221)	-	(221)
Currency translation adjustments	-	-	-	-	8,254	-	8,254
Total comprehensive income	-	-	-	-	-	-	45,292
Implementation of FSP EITF 00-19-2	-	-	-	236	-	-	236
Cumulative impact of change in accounting for uncertainties in income taxes (FIN 48)	-	-	-	(430)	-	-	(430)
Balance as of December 31, 2007	13,200,000	3,736	132,545	69,229	(6,863)	(259)	198,388

Accumulated unrealized gain
from available - for-sale
securities

Accumulated currency translation adjustments	(6,891)
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Accumulated other comprehensive loss	(6,863)
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* Net of issuance expenses on the amount of \$3,000 thousand.

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,		
	2007	2006	2005
(U.S. \$ in thousands)			
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	37,259	10,015	183
Adjustments to reconcile net income to net cash provided by operating activities:			
Impairment and write down of other investments and fixed assets	649	956	138
Impairment of available for sale marketable securities	1,789	-	-
Minority interest in earnings of consolidated subsidiaries	15,464	13,523	1,491
Equity in losses (gains) of affiliated companies, net	653	(459)	3,109
Depreciation and amortization	15,806	44,887	25,130
Increase in accrued severance pay, net	542	1,839	108
Gain from sale of subsidiaries	(28,037)	(2,485)	-
Loss (gain) from sale of operation	(170)	917	-
Loss (gain) from sale of property and equipment	(70)	15	(20)
Gain on realization of shareholdings	(2,039)	(38,500)	(4,107)
Amortization of deferred option compensation	1,074	59	134
Increase in value and accrued interest on debentures and changes in embedded derivative	1,691	255	1,699
Changes in value of long term loans and deposits, net	1,963	2,249	247

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Deferred taxes	(2,563)	(2,353)	(391)
Change in liability in respect of acquisition	(493)	-	-
Loss (gain) from sale and decrease (increase) in value of marketable securities, net	60	(1,219)	1,598
Changes in operating assets and liabilities:			
Decrease (increase) in inventories	(134)	1,008	237
Increase in trade receivables	(8,415)	(26,045)	(20,717)
Decrease (increase) in other accounts receivable	(7,296)	2,499	(472)
Increase in trade payables	4,082	9,573	5,038
Increase (decrease) in other accounts payable and restructuring accrual	10,336	12,045	(7,265)
Increase (decrease) in customer advances, net of work in progress	1,114	(2,829)	146
Net cash provided by operating activities	43,265	25,950	6,286

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,		
	2007	2006	2005
(U.S. \$ in thousands)			
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisition of newly-consolidated subsidiaries (Appendix C)	(5,391)	(15,928)	(5,342)
Proceeds from realization of investment in previously-consolidated subsidiaries (Appendix D)	39,499	(1,581)	-
Proceeds from sale of activity in a consolidated company	170	2,895	-
Proceeds from repayment of debentures	-	-	(41)
Restricted short term deposit, net	-	5,290	(3,918)
Restricted long term deposit, net	2,506	(2,533)	1,434
Purchase of property and equipment	(4,345)	(6,460)	(6,006)
Purchase (proceeds) of short term investment , net	(26,297)	3,917	6,100
Proceeds from sale of property and equipment	186	838	1,963

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Investment in and loans to affiliated and other companies	(499)	(8,900)	(1,582)
Proceeds from sale of investments in and loans to affiliated companies	-	46,558	813
Purchase of an activity by a consolidated company	-	-	(111)
Purchase of intangible assets by consolidated companies	-	(50)	-
Investment in long term bank deposits, net	(9,881)	489	(698)
Capitalization of software development and other costs	(8,522)	(18,837)	(17,743)
Purchase of minority interest in subsidiaries	(6,281)	(9,737)	(2,253)
Proceeds from realization of investment in subsidiaries	-	9,661	4,331
Proceeds from investments in short term bank deposits, net	-	595	(1,118)
Net cash provided (used) in investing activities	(18,855)	6,217	(24,171)

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended December 31,

2007	2006	2005
(U.S. \$ in thousands)		

CASH FLOWS FROM FINANCING ACTIVITIES:

Spin-off consolidated company (Appendix D)	-	(24,154)	-
Issuance of debentures (net from issuance expense)	61,576	-	-
Issuance of convertible debt	-	14,140	-
Issuance of shares	-	-	33,307
Exercise of share options in subsidiaries	4,888	7,570	2,217
Dividend distribution	-	-	(50,185)
Dividend to minority shareholders in subsidiaries	(8,348)	(4,239)	(8,352)
Short-term bank credit, net	(16,944)	(17,780)	5,467
Repayment of long-term loans	(61,630)	(9,676)	(19,629)
Receipt of long-term loans	26,275	31,372	51,156

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Issuance in a subsidiary to minority shareholders, net	12,915	5,998	5,344
Convertible debt issuance expenses in a subsidiary	-	(655)	-
Deposit for SWAP deal	(1,040)	-	-
Repayment and repurchase of debenture	(7,818)	(6,219)	(18,357)
Proceeds from sale of treasury stock of subsidiary	3,017	-	-
Purchase of treasury stock in a subsidiary by a subsidiary thereof	-	(307)	(4,134)
Net cash provided (used) by financing activities	12,891	(3,950)	(3,166)
Effect of exchange rate changes on cash and cash equivalents	7,824	6,418	(4,356)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	45,125	34,635	(25,407)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR(*)	116,401	81,767	107,174
CASH AND CASH EQUIVALENTS AT END OF YEAR	161,526	116,402	81,767

(*) Include cash and cash equivalents of discontinued operations.

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

Appendix A Supplemental cash flow information:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Cash paid during the year in respect of:			
Interest	6,107	9,965	10,052
Income tax	6,648	7,717	7,467

Appendix B Non-cash activities:

Year ended December 31,

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	2007	2006	2005
	(U.S. \$ in thousands)		
Purchase of fixed assets against trade payables	-	21	343
Investment in a consolidated company against issuance of share capital to minority shareholders of consolidated company	-	275	1,577
Investment in a consolidated company against account payable	949	-	-
Purchase of shares from minority shareholders of subsidiary, against accounts payable	-	-	100
Investments in available marketable securities, against accounts payable	-	884	-
Exchange of assets in a subsidiary	-	-	70
Fin 48 provision	430	-	-
Current maturities of royalties liabilities against account receivables	-	-	13

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

Appendix C Acquisition of newly-consolidated subsidiaries:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Assets and liabilities of subsidiaries consolidated as of acquisition date:			
Working capital (other than cash and cash equivalents)	3,603	2,327	5,446
Liabilities arising from the acquisition	-	-	209
Investment in affiliates and loans	375	370	801
Property and equipment	(308)	(480)	(813)

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Other assets and deferred expenses*	(10,857)	(3,985)	(4,697)
Other assets arising upon acquisition	-	(13,855)	(7,981)
Long-term liabilities	925	(305)	533
Other long term assets	(212)	-	-
Long term deferred tax	(64)	-	-
Issuance of shares by a subsidiary	-	-	1,408
Minority interest at acquisition date	1,147	-	(248)
Total	(5,391)	(15,928)	(5,342)

* Mainly goodwill

Appendix D - Proceeds from realization of investments in previously-consolidated subsidiaries:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Assets and liabilities of consolidated subsidiaries as of date of realization			
Working capital (other than cash and cash equivalents)	9,434	(43,835)	-
Debtors from sale of subsidiaries	(16,000)	-	-
Investments and loans in subsidiaries	-	13,056	-
Accrued severance pay, net	(2,036)	(2,175)	-
Investment in affiliate (including loans)	(4,151)	1,642	-
Property and equipment	2,843	4,546	-
Other assets, deferred expenses and long term payables	37,032	43,520	-
Provision for losses	(1,971)	-	-
Long term deposits	1,181	368	-
Goodwill	54,462	6,462	-
Other comprehensive (loss) gain	570	(755)	-
Long-term liabilities	(28,833)	(246)	-
Gain (loss) from realization of investments in subsidiaries	28,037	(4,383)	-
Retained earnings	-	(27,015)	-
Minority interest	(41,069)	(16,920)	-
Total	39,499	(25,735)	-

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

FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies:

General:

Formula Systems (1985) Ltd. (Formula) was incorporated in Israel in 1985. Since 1991, Formula's shares have been traded on the Tel Aviv Stock Exchange (the TASE) and since 1997, through American Depositary Shares (ADS) under the symbol FORTY on the NASDAQ Global Market in the United States. Each ADS represents one ordinary share of Formula.

Formula, through its subsidiaries (collectively, the Company or the Group) is engaged in the development, production and marketing of information technology (IT) solutions and services. The Group operates in two reportable segments: IT Services and Proprietary Software Solutions. For a description of the segments see Note 15H.

The following table presents certain information regarding the control and ownership of Formula's significant subsidiaries and material investments, as of the dates indicated:

Name of subsidiary:

	Percentage of ownership and control	
	December 31, 2007	December 31, 2006
	%	
Matrix IT Ltd. (Matrix)	50.13	50.26
BluePhoenix Solutions Ltd. (BluePhoenix) (formerly - Crystal Systems Solutions Ltd.)	*-	56.22
Magic Software Enterprises Ltd. (Magic)	51.26	50.01
NextSource Inc.	100.00	100.00
Sapiens International Corporation N.V. (Sapiens)	54.60	61.96

The above list consists only of active companies that are held directly by Formula.

* See note 2A

Accounting Principles

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) as applied in the United States.

FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

A. Functional and Reporting Currency:

Beginning in 2007, the Company changed its functional currency from NIS to the United States dollar (dollar). This was done according to a change in economic and circumstance factors for the Company, as mentioned in financial accounting standards board statement No. 52 foreign currency translation . Prior to 2007, Formula operated primarily in the economic environment of the New Israeli Shekel (NIS) and its functional currency was the NIS. The functional currencies of Formula s subsidiaries are the NIS and the dollar. Formula has elected to use the dollar as its reporting currency for all years presented.

Formula translates the financial statements of its subsidiaries whose functional currency is the NIS, into dollars, under the principles described in Financial Accounting Standards Board Statement No. 52. Assets and liabilities have been translated at period-end exchange rates. Results of operations have been translated at the exchange rate at the dates on which those transactions occurred or at an average rate. Formula presents differences resulting from translation under shareholders equity in the item accumulating other comprehensive income (loss).

The comparative figures for 2006 and 2005 have been measured under the assumption that formula s functional currency was the NIS.

The financial statements of prior years of Formula and most of its subsidiaries whose functional currency is the NIS have been translated into dollars under the principles described in Financial Accounting Standards Board Statement No. 52, Foreign Currency Translation . Assets and liabilities have been translated at period-end exchange rates. The results of operations have been translated at the exchange rates on the dates on which the transactions occurred or at average exchange rates. Differences resulting from translation are presented under shareholders equity, in the item accumulated other comprehensive loss .

B. Use of Estimates and Assumptions in the Preparation of the Financial Statements:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The actual results may differ from these estimates.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

C. Principles of Consolidation:

The consolidated financial statements include Formula s financial statements as well as those of its subsidiaries in which it has a controlling interest. Acquisition of subsidiaries is accounted for under the purchase method. All inter-company balances and transactions have been eliminated upon consolidation.

D. Cash and Cash Equivalents:

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Cash equivalents are considered by the Company to be highly-liquid investments, including, inter-alia, short-term deposits with banks, the maturity of which did not exceed three months at the time of acquisition and which are unrestricted.

E. Investments:

Investments in non-marketable securities of companies in which the Company does not have the ability to exercise significant influence over operating and financial policy are recorded at cost. The Company accounts for investments in marketable equity securities and debt securities in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115). Marketable equity securities and debt securities that are classified as trading or as available-for-sale are reported at fair value.

Unrealized gains and losses from marketable securities classified as available for sale are excluded from earnings and are reported as a component of accumulated other comprehensive income (loss) in shareholders' equity.

Unrealized gains and losses from marketable securities classified as trading are reported in the statement of income.

Investments are periodically reviewed to determine whether other-than-temporary impairment in value has occurred, in which case the investment is written down to its fair value, Through the income statements.

F. Provision for Doubtful Accounts:

The provision for doubtful accounts was calculated on the basis of specific receivables, where, in the opinion of Group management, doubt exists as to their collectability.

G. Inventory:

Inventory is comprised of hardware and software.

Inventory is valued at the lower of cost or market value. Cost is determined on the first in - first out basis for hardware.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

H. Investments in Affiliates:

Affiliates are companies over which significant influence is exercised, but which are not consolidated subsidiaries, and are accounted for by the equity method, net of write-down for decrease in value, which is not of a temporary nature.

I. Property and Equipment, net:

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

	<u>%</u>
Computers and equipment	7-33
Motor vehicles	15
Buildings	2-4
Leasehold improvements	-*

*Over the term of the lease or the estimated useful life of the assets, whichever is shorter.

J. Goodwill:

The Company applies Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142). SFAS 142 requires goodwill to be tested for impairment on an annual basis and more frequently in certain circumstances, and written down when impaired rather than being amortized. Furthermore, SFAS 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless those lives are determined to be indefinite.

The Company has selected December 31st as the date on which it will perform its annual goodwill impairment test.

Goodwill related to equity method investees is not amortized (as of January 1, 2002 and thereafter) but the investment is tested for impairment under the provisions of APB 18.

As of December 31, 2007, 2006 and 2005, no impairment was required.

K. Software Development Costs:

Development costs of software, which is intended for sales that are incurred after the establishment of technological feasibility of the relevant product, are capitalized. Technological feasibility is determined when detailed program design is completed and verified in accordance with the provisions of SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed .

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

K. Software Development Costs (cont.):

Software development costs incurred before technological feasibility has been established are charged to the statement of operations as incurred, net of participation of the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade (the OCS).

Amortization of capitalized software development costs begins when the product is available for general release to customers. Annual amortization is calculated according to the higher of the straight-line method over the remaining useful life of the product or based on the ratio of current gross revenues to current and anticipated future gross revenues. At present, amortization is computed under the straight-line method, mainly over a period of 3-5 years. During the year ended December 31, 2007, consolidated subsidiaries capitalized software development costs aggregating \$6.2 million (2006 - \$8.5 million, 2005 - \$8.4 million) and amortized capitalized software development costs aggregating \$6.4 million (2006 - \$8.9 million, 2005 - \$7.4 million).

Management estimates that the total capitalized costs do not exceed the net realizable value of the software product. In the event that unamortized software development costs exceed the net realizable value of the product, they are written down to net realizable value. As of December 31, 2007, no impairment was recorded.

L. Other Intangible Assets:

Other intangible assets are comprised of customer s related intangible assets and acquired technology and are amortized over their useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up. Customers and acquired technology are amortized over a period of 8 and 5-10 years, respectively. The Company reviews the useful life of its intangible assets annually.

M. Impairment in Value of Long-Lived Assets:

The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS No. 144), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. During 2007, impairment loss in the amount of \$137 thousand has been identified. For the years ended December 31, 2006 and 2005, no impairment losses have been identified.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

N. Severance Pay:

The Company's liability for severance pay to its employees pursuant to Israeli law and employment agreements is covered in part by managers' insurance policies, for which the Company makes monthly payments. The value of these policies is recorded as an asset in the Company's balance sheet. The Company may only make withdrawals from the managers' insurance policies for the purpose of paying severance pay. The severance pay liability is calculated on the basis of one month's salary for each year of service, based on the most recent salary of each employee.

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

The expenses in respect of severance pay for the years ended December 31, 2007, 2006 and 2005 were \$9.3 million, \$5.6 million and \$6.4 million, respectively.

O. Revenue Recognition:

Revenues derived from direct software license agreements are recognized in accordance with Statement of Position (SOP) 97-2 Software Revenue Recognition (as amended by SOP 98-4 and SOP 98-9), upon delivery of the software when collection is probable, where the license fee is otherwise fixed or determinable, and when there is persuasive evidence that an arrangement exists.

In addition, there are certain arrangements involving multiple elements such as software product, maintenance and support.

For these multiple elements, SOP 97-2 requires that the fair value of each component in a multiple element arrangement will be determined based on the vendor's specific objective evidence (VSOE) for that element, and revenue is allocated to each component based on its fair value.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

O. Revenue Recognition (cont.):

SOP 98-9 requires that revenue be recognized under the residual method when VSOE does not exist for all the delivered elements, VSOE of fair value exists for all undelivered elements, and all other SOP 97-2 criteria are met. Under the residual method, any discount in the arrangement is allocated to the delivered elements.

The VSOE for maintenance and support is established by the price charged on other time based consulting service contracts where no sale of other elements is involved. The revenue associated with the delivered elements is recognized using the residual method discussed above.

Revenues from consulting services, consisting of billable hours for services provided, are recognized as the services are rendered.

Revenues from maintenance and training contracts are recognized relatively over the contract period.

The Company recognizes revenues from consulting fees with respect to projects billed on a time and material basis, based on the number of hours performed.

The Company recognizes revenues from projects as follows:

- (i) Revenue from projects billed on a time and material basis is recognized in accordance with SOP 81-1 Accounting for Performance of Construction - Type and Certain Production - Type Contracts , using contract accounting on a percentage of completion method, on the basis of the relationship between actual costs incurred and the total costs that are expected to be incurred over the duration of the contract. Provision is made for estimated losses and uncompleted contracts, in the amount of the estimated losses on the entire contract in the period in which such losses first become evident.
- (ii) Revenue from fixed fee contracts is also recognized in accordance with the percentage of completion method. The Company recognizes contract losses, if any, in the period in which they first become evident.

Revenues from sale of hardware are recognized when the merchandise is delivered to the customer, provided no significant vendor obligations remain.

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

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

O. Revenue Recognition (cont.):

Deferred revenue includes unearned amounts received under maintenance contracts and amounts received from customers but not yet recognized as revenues. Payments for maintenance fees are generally made in advance and are nonrefundable.

Management believes that the Company's revenue recognition policies are in accordance with the Securities and Exchange Commission Staff Accounting Bulletin No. 101 and SAB 104, Revenue Recognition in Financial Statements .

P. Government Grants:

Royalty-bearing grants from the Government of Israel for the funding of research and development projects are recognized at the time that the Company is entitled to such grants on the basis of the related costs incurred, and are recorded as a deduction from research and development costs. The Company also received non-royalty-bearing grants from the Fund for the Encouragement of Marketing Activity. These grants are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred, and included as a deduction from selling, marketing, general and administrative expenses.

Q. Provision for Warranty:

In light of past experience, Formula and its subsidiaries do not record any provision for warranties in respect of their products and services.

R. Advertising Costs:

The Company records advertising expenses as incurred. Advertising costs were recorded on the amount of \$5.1 million, \$2.4 million, and \$1.5 million in the years 2007, 2006, 2005 respectively.

S. Gain on Realization of Shareholdings:

Gain on realization of shareholdings includes the results of realization of the Company's shareholdings in investees arising either on the sale of such shareholdings or from the issuance of stock by the investees to third parties, which is recognized in accordance with the provisions of Staff Accounting Bulletin (SAB) No. 51 issued by the Securities and Exchange Commission. The Company charges such results to the statement of operations, provided that the conditions stipulated by SAB 51 for such recognition have been met.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

T. Deferred Income Taxes:

Formula and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standard No. 109, Accounting for Income Taxes (SFAS No. 109). This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on the differences between the 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. Formula and its subsidiaries provide a valuation allowance, where necessary, in order to reduce deferred tax assets to an amount that is more likely than not to be realized, in future years.

In September 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48, on January 1, 2007

U. Earnings (Loss) Per Share:

Earnings per share (EPS) are calculated in accordance with the provisions of SFAS No. 128 of the FASB (SFAS 128). SFAS 128, Earnings per Share requires the presentation of both basic and diluted EPS.

Basic net earnings per share are calculated on the basis of the weighted average number of common shares outstanding during each year. The diluted earnings per share are calculated on the basis of the weighted average number of common shares outstanding during each year, plus the dilutive potential common shares considered outstanding during the year.

V. Treasury Shares Held by the Company:

Shares of the Company that are held by the Company (treasury shares) are presented as a reduction of shareholders' equity, at their cost to the Company. Gains and losses upon the sale of these shares, net of related income taxes, are carried to additional paid-in capital and to retained earnings, respectively.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

W. Concentration of Credit Risks - Allowance for Doubtful Accounts:

Most of the Group's cash and cash equivalents and short-term investments as of December 31, 2007 and 2006 were deposited in Israeli, U.S. and European banks. The Company is of the opinion that the credit risk in respect of these balances is remote.

Most of the Group's sales are made in Israel and North America, to a large number of customers.

The Group's trade receivables are derived from sales to large firm organizations located mainly in North America and Israel. The Group performs ongoing credit evaluations of its customers and has established an allowance for doubtful accounts based upon factors relating to the credit risk of specific customers and other information. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees. From time to time, the Company sells certain of its accounts receivable to financial institutions, within the normal course of business.

SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS No. 140), establishes a standard for determining when a transfer of financial assets should be accounted for as a sale. The underlying conditions are met for the transfer of financial assets to qualify for accounting as a sale. The transfers of financial assets are typically performed by the sale of receivables to a financial institution.

The agreements, pursuant to which the Company sells its trade receivables, are structured such that the Company (i) transfers the proprietary rights in the receivable from the Company to the financial institution; (ii) legally isolates the receivable from the Company's other assets, and presumptively puts the receivable beyond the legal reach of the Company and its creditors, even in bankruptcy or other receivership; (iii) confers on the financial institution the right to pledge or exchange the receivable; and (vi) eliminates the Company's effective control over the receivable, in the sense that the Company is not entitled and shall not be obligated to repurchase the receivable other than in case of failure by the Company to fulfill its commercial obligation.

Formula and its subsidiaries had no off-balance-sheet concentration of credit risk as of December 31, 2007.

The provision for doubtful accounts charged to general and administrative expenses amounted to \$0.58 million, \$1.3 million and \$1.7 million in the years 2007, 2006 and 2005, respectively, and was determined for specific debts where doubt existed as to their collectability.

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

X. Options Granted to Employees:

On January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123 (revised 2004) (FAS 123R), Share-Based Payment, and Staff Accounting Bulletin No. 107 (SAB 107), which was issued in March 2005 by the SEC. FAS 123R addresses the accounting for share-based payment transactions in which the Company obtains employee services in exchange for equity instruments of the Company. This statement requires that employee equity awards be accounted for using the grant-date fair value method. SAB 107 provides supplemental implementation guidance on FAS 123R, including guidance on valuation methods, classification of compensation expense, income statement effects, disclosures and other issues.

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FAS 123R supersedes the Company's previous accounting for its employee stock option plans using the intrinsic value-based method of accounting prescribed under Accounting Principles Board Opinion No. 25 (APB 25) and related interpretations. The Company elected to adopt the modified prospective transition method permitted by FAS 123R. Under such transition method, the new standard has been implemented from January 1, 2006, with no restatement of prior periods to reflect the fair value method of expensing share-based compensation.

The Company has expensed compensation costs, applying the accelerated vesting method, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and previously presented in the pro forma footnote disclosures. Results for prior periods have not been restated as explained above. For the year ended December 31, 2007, the Company's subsidiaries recorded stock-based compensation costs in the amount of \$1.07 million. The total unrecognized compensation cost on employee stock options amounted to \$2.4 million on December 31, 2007, and is expected to be recognized up to 5 years.

The Company issues stock options to its employees and directors and provides the right to purchase stock pursuant to approved stock option .. Prior to the adoption of FAS 123R, the Company elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Options Issued to Employees and related interpretations (collectively APB No. 25), in accounting for its stock option plans. Under APB No. 25, when the exercise price of an employee stock option is less than the market price of the underlying stock on the date of grant, compensation expense is recognized.

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

X. Options Granted to Employees (cont.):

Compensation costs in respect of such plans in the net amounts of \$70 thousand were charged to income in 2005. Had the compensation costs in respect of the Company's plans been determined based on the fair value at the grant date, consistent with the method of SFAS 123 as amended by SFAS 148, the Company's net income and earnings per share would have been decreased to the pro-forma amounts indicated below:

	Year Ended December 31, 2005
	(U.S. \$ in thousands except per share amounts)
Net income from continuing operations, as reported	1,766
Add: Stock-based employee compensation expenses included in reported net income, net of related tax effects	70
Less: Total stock-based employee compensation expenses determined under the fair value based method for all awards, net of related tax effects	(3,180)
Pro-forma net income	(1,344)
Earnings per share from continuing operations:	
Basic - as reported	0.14

Basic - pro forma	(0.10)
Diluted - as reported	0.14
Diluted - pro forma	(0.10)

Y. Derivatives and Hedging:

The Company accounts for derivatives based on Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities as amended (SFAS No. 133). SFAS 133 requires companies to recognize all of its derivative instruments at fair value. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship.

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FORMULA SYSTEMS (1985) LTD.**(An Israeli Corporation)****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****Note 1 Summary of Significant Accounting Policies (cont.):****Y. Derivatives and Hedging (cont.):**

Some subsidiaries enter into forward exchange contracts to hedge certain transactions denominated in foreign currencies. The purpose of Company's foreign currency hedging activities is to protect the subsidiaries from risk that the eventual dollar cash flow from international activities will be adversely affected by changes in the exchange rates. The subsidiaries' forward contracts did not qualify as hedging instruments under SFAS No. 133. Changes in the fair value of forward contracts are reflected in the consolidated statements of operations as financial income or expense.

Put options which were granted to minority interest during 2007 in a subsidiary have been measured in fair value pursuant to EITF 00-06 Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary. Changes in the fair value are reflected in the consolidated statements of operations as financial income or expense.

In addition, during 2007 the Company's subsidiary engaged in Swap deal to exchange interest which was linked to the CPI. This Swap deal did not qualify as hedging instrument under SFAS 133. Changes in the fair value are reflected in the consolidated statements of operation as financial income or expense.

Z. Fair Value of Financial Instruments:

The estimated fair value of financial instruments has been determined by the Company using available market information and valuation methodologies. Considerable judgment is required in estimating fair values. Accordingly, the estimates may not be indicative of the amounts the Company could realize in a current market exchange. The carrying amounts of cash and cash equivalents, trade receivables, short-term bank credit and trade payables approximate their fair values due to the short-term maturity of such instruments. The fair value for marketable securities is based on quoted market prices and do not significantly differ from a carrying amount.

The carrying amounts of the Company's long-term borrowing arrangements approximate their fair value. Fair values were estimated using discounted cash flow analyses, based on prevailing market borrowing rates.

The fair value of the convertible debentures with a carrying value in the amount of \$10.9 million as of December 31, 2007 according to the quoted price in the Tel-Aviv Stock Exchange (TASE) is \$10.3 million.

AA. Spin-off of the Investment in Formula Vision

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In December 2006, the company spun-off its investment in Formula Vision to its shareholders. Formula Vision's shares were distributed to the Company's shareholders at a pro-rata basis. According to APB 29 the spin off was accounted as a decrease in the Company's retained earnings and measured according to the book value of the investment as of the spin-off date (see also note 2E).

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

AB. Discontinued operations:

Under SFAS 144, when a component of an entity, as defined in SFAS 144, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on its disposal should be classified as discontinued operations and the assets and liabilities of such component should be classified as assets and liabilities attributed to discontinued operations. The operations, assets and liabilities of the component have been eliminated from the Company's consolidated operations and the Company will no longer have any significant continuing involvement in the operations of the component.

AC. Recently Issued Accounting Pronouncements:

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). This statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. The statements does not apply to accounting standard that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

On February 12, 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157 (the FSP). The FSP amends FASB Statement No. 157, Fair Value Measurements (Statement 157), to delay the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). For items within its scope, the FSP defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

The Company is currently evaluating the impact that this pronouncement may have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. This statement provides companies with an option to report selected financial assets and liabilities at fair value. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings.

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

AC. Recently Issued Accounting Pronouncements (cont.):

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The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. This Statement is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact that this pronouncement may have on its consolidated financial statements.

On December 21, 2007 the SEC staff issued Staff Accounting Bulletin No. 110 (SAB 110), which, effective January 1, 2008, amends and replaces SAB 107, Share-Based Payment. SAB 110 expresses the views of the SEC staff regarding the use of simplified method in developing an estimate of expected term of plain vanilla share options in accordance with FASB Statement No. 123 (R), Share-Based Payment. Under the simplified method, the expected term is calculated as the midpoint between the vesting date and the end of the contractual term of the option.

The use of the simplified method, which was first described in staff Accounting Bulletin No. 107, was scheduled to expire on December 31, 2007. SAB 110 extends the use of the simplified method for plain vanilla awards in certain situations. The SEC staff does not expect the simplified method to be used when sufficient information regarding exercise behavior, such as historical exercise data or exercise information from external sources, becomes available.

The adoption of SAB 110 will impact the consolidated financial statements since the Company's subsidiary uses the simplified method in developing an estimate of the expected term on its share options.

In December 2007, the FASB issued SFAS 141(R), Business Combinations. This Statement replaces SFAS 141, Business Combinations, and requires an acquirer to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration, and any non controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the statement. SFAS 141(R) also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the non controlling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141(R)). In addition, SFAS 141(R)'s requirement to measure the non controlling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the non controlling interest in addition to that attributable to the acquirer. SFAS 141(R) amends SFAS No. 109, Accounting for Income Taxes, to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the business combination or directly in contributed capital, depending on the circumstances.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies (cont.):

AC. Recently Issued Accounting Pronouncements (cont.):

It also amends SFAS 142, Goodwill and Other Intangible Assets, to, among other things, provide guidance on the impairment testing of acquired research and development intangible assets and assets that the acquirer intends not to use. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

The Company is currently evaluating the impact that this pronouncement may have on its consolidated financial statements.

In December 2007, the FASB issued SFAS 160, No controlling Interests in Consolidated Financial Statements. SFAS 160 amends Accounting Research Bulletin 51, Consolidated Financial Statements, to establish accounting and reporting standards for the no controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a no controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the no controlling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the no controlling interest. SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the no controlling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal

years, beginning on or after December 15, 2008.

The Company is currently evaluating the impact that this pronouncement may have on its consolidated financial statements.

Note 2 Certain Transactions:

- A. In June, 2007 the company sold its entire holdings in BluePhoenix, for consideration of approximately \$64 million. The company recognized approximately \$18 million in capital gains upon completion of the sale of ordinary shares. This gain is presented in the income statement as income from discontinued operation.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Certain Transactions (Cont.):

- B. On December 30, 2007, the Company's subsidiary, Magic, sold its wholly-owned subsidiary, Advanced Answers on Demand Holding Corporation, or AAOD, a Florida corporation that develops and markets application software targeted at the long-term care industry, to Fortissimo Capital for \$17 million. Fortissimo paid Magic \$1 million of the sale price in December 2007 and the remaining \$16 million in March 2008. As a result of this sale, the Company recorded a net gain of approximately \$9.3 million; this gain is presented in the income statement as an income of discontinued operation. In addition, as part of the transaction, Magic entered into a three years license agreement with AAOD according to which AAOD will continue to sell Magic's products, as an OEM partner, in consideration for \$3 million, to be paid quarterly over three years starting in 2008.
- C. On August 19, 2007, the Company's subsidiary, Matrix, completed an offering of non-convertible debentures in an aggregate principal amount of approximately \$62 million (NIS 250 million). The debentures were sold to institutional and other investors in Israel. The debentures bear an interest at an annual rate of 5.15%. The principal will be paid in four equal annual installments on December 31 of each of the years 2010 through 2013. The principal and interest are linked to the Israeli consumer price index. On February 21, 2008, Matrix listed the debentures for trading on the TASE.
- D. In June 2007, the Company's subsidiary, Sapiens, entered into a private placement investment transaction with several institutional investors, private investors and Formula for an aggregate gross investment amount of \$20 million (excluding finders' fees and out of pocket expenses), \$6.5 million of which was by Formula. Sapiens issued to the investors an aggregate of 6,666,667 common shares (of which 2,166,666 common shares were issued to Formula), at a price per share of \$3.00 which reflected a premium of approximately 25% above the trading price of Sapiens' common shares (as of the date Sapiens' board of directors approved the investment).

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Certain Transactions (Cont.):

E. (cont.):

In December, 2006, the Company spun-off Formula Vision. Therefore, Formula Vision is no longer a subsidiary of the Company. The spin-off was affected by way of distributing the 36,696,000 Formula Vision shares owned by Formula (then representing approximately 57% of the outstanding Formula Vision shares) to Formula's shareholders on a pro-rata basis. The Formula Vision shares were distributed at a ratio of 2.78 Formula Vision shares for each outstanding Ordinary Share held at the close of the trade on December 14, 2006, the record date, subject to withholding taxes.

F. In April 2000, FID and Israel Discount Bank Ltd. (the Investors) invested \$15 million in eZoneXchange.com, Inc. (eZone), a subsidiary of Sapiens. The private placement to the Investors was accompanied by a Put/Call Agreement, according to which the Investors were granted the right to require us to repurchase their shares in the subsidiary beginning May 2004 in exchange for both cash and Sapiens Common Shares.

In February 2001, the management decided to discontinue the operations of eZone. During the same period, Sapiens agreed to a partial exercise of Investors' put option, resulting in a payment to them of \$4.5 million.

On March 16, 2004, Sapiens entered into a new agreement with the Investors which replaced the Put/Call agreement and which restructured the remaining portion of the put option. Sapiens agreed to issue the investors, in a private placement, 750,000 common shares and warrants to purchase 350,000 additional common shares that are exercisable through December 31, 2007. In addition, Sapiens agreed to pay the investors in two annual installments a total of \$8.6 million plus interest at 7.5% a year by May 1, 2005. The first installment of \$4.6 million was paid as required at the beginning of May 2004.

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 2 Certain Transactions (Cont.):

F. (cont.):

In May 2005, Sapiens entered into an agreement with the Investors regarding the payment of the remaining \$4.0 million due to the investors, pursuant to the March 2004 agreement between Sapiens and the Investors. Sapiens agreed to pay \$2.0 million on May 2, 2005, \$1.0 million by April 1, 2006 and \$1.0 million by August 1, 2006. The investors may, at their sole discretion, convert all or any portion of the \$1.0 million payable on August 1, 2006 into Sapiens common shares, at a conversion price per each share of \$3.20. In addition, the interest to be paid on the outstanding principal amount was changed to LIBOR plus 2.5%. The first installment of \$2.0 million was paid as required at the beginning of May 2005.

In August 2006, Sapiens entered into an agreement with the Investors whereby the Investors converted the \$1.0 million payment that was due on April 1, 2006 into 781,250 of Sapiens common shares and the payment of the \$1.0 million payment due on August 1, 2006 was delayed to August 1, 2007. In August 2007, Sapiens repaid the remaining outstanding balance of \$ 1.0 million due to the investors, per the agreement described above.

G. In March 2005, Formula completed a private placement of 2,400,000 Formula shares for an aggregate consideration of \$33 million. The shares were issued to FIMGold LP, an entity owned in equal shares by Dan Goldstein (Formula's CEO and chairman of the board - at that time) and FIMI Opportunity Fund. Concurrently with the closing of the private placement, Dan Goldstein sold to FIMGold LP all of his holdings in Formula and Formula Vision. Following these transactions, FIMGold LP held 33.3% controlling interest in Formula and approximately 24% interest in Formula Vision.

Note 3 Short-term Investments:

A. Comprise:

<u>Interest rate</u>	<u>December 31,</u>	
<u>December 31,</u>	<u>2007</u>	<u>2006</u>
<u>2007</u>	<u>2007</u>	<u>2006</u>
%	(U.S. \$ in thousands)	

Trading securities	-	31,700	6,635
Available-for-sale securities	-	8,487	8,327
Short-term deposits	1.2	89	69
Total		40,276	15,031

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FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****Note 3 Short-term Investments (Cont.):****B. The following is a summary of marketable securities which are classified as available-for-sale:**

	December 31,					
	2007			2006		
	(U.S. \$ in thousands)					
	Amortized cost	Unrealized gains (losses)	Market value	Amortized costs	Unrealized losses	Market value
Available-for-sale:						
Government debentures	1,216	58	1,274	1,641	(15)	1,626
Marketable securities *	1,545	-	1,545	3,646	-	3,646
Commercial debentures	5,392	74	5,466	2,855	(30)	2,825
Equity funds	249	(47)	202	249	(19)	230
Total available-for-sale marketable securities	8,402	85	8,487	8,391	(64)	8,327

In 2007, the Company recorded proceeds from sales of marketable securities on the amount of \$721 thousand and related losses of \$17 thousand in financial income, net.

Since the Company has the ability and intent to hold these investments until a recovery of fair value, the Company does not consider these investments to be other than temporarily impaired as of December 31, 2007. In addition, these securities have been in a continuous unrealized losses position for a period not more than 12 months.

* In 2007, the Company recorded impairment charges in the amount of \$1.7 million.

The estimated fair value of available-for-sale investments as of December 31, 2007 by contractual maturity, are as follows:

	December 31,			
	2007		2006	
	(U.S. \$ in Thousands)			
	Cost	Market value	Cost	Market value
Available-for-sale debt securities:				
Matures in one year	3,273	3,272	679	670
Matures in one to five years	2,731	2,826	3,218	3,182
Matures in more than five years	604	642	605	599
	<u>6,608</u>	<u>6,740</u>	<u>4,502</u>	<u>4,451</u>

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 4 Loans and Other Investments:

Comprise:

	Interest rate	Linkage basis	December 31,	
			2007	2006
			(U.S. \$ in thousands)	
	%			
Cost of shares (1)			1,090	62
Long-term prepaid expenses			1,612	208
Restricted deposit	4.3-6	Dollar	400	2,907
Restricted deposit	-	Unlinked	1,040	-
Deposit	0-6	Dollar	10,473	123
Deposit	-	CPI	234	162
Deposit	0-3	Yen	-	378
Deposit	-	Euro	-	3
Deposit	-	GBP	-	18
			<u>12,147</u>	<u>3,591</u>
Total			<u>14,849</u>	<u>3,861</u>

- (1) In 2007 impairment losses on cost investments have been identified in the amount of \$512 thousand. In 2006 no impairment losses on cost investment was identified.

Note 5 Investments in Affiliates:

A. The investments are composed and presented as follows:

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
Investment in shares:		
Cost	4,369	557
Goodwill and allocated original excess cost *	(265)	(205)
Net asset value as of acquisition date	4,104	352
Equity in post-acquisition undistributed retained earnings , net	(577)	163
Net asset value as of the balance sheet date	3,527	515
Balance of goodwill	265	205
Total	3,792	720

* Beginning on January 1, 2002, the investment is being tested for impairment on an annual basis rather than amortizing the goodwill as required by previous accounting standards (see Note 1J).

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FORMULA SYSTEMS (1985) LTD.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 5 Investments in Affiliates (Cont.):

B. Following are details relating to the financial position and results of operations of affiliates in the aggregate:

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	

Total assets	16,556	6,592
Total liabilities	6,487	346
Net (loss) income	(2,037)	64

Note 6 Property and Equipment, net:**Comprise:**

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
Cost:		
Computers and equipment	52,603	50,721
Motor vehicles	1,015	1,052
Buildings	10,597	10,034
Leasehold improvements	8,196	7,025
	<u>72,411</u>	<u>68,832</u>
Accumulated Depreciation:		
Computers and equipment	45,294	43,828
Motor vehicles	705	655
Buildings	4,822	3,914
Leasehold improvements	5,796	4,514
	<u>56,617</u>	<u>52,911</u>
Depreciated balance	<u>15,794</u>	<u>15,921</u>

Depreciation expenses totaled \$4.3 million, \$4.7 million and \$4.9 million for the years ended December 31, 2007, 2006 and 2005, respectively.

See Note 12B with respect to pledges.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 7 Goodwill:

The changes in the carrying amount of goodwill for the year ended December 31, 2007 and 2006 are as follows:

	U.S. \$ in thousands
Balance as of January 1,2006	95,858
Acquisition of additional interest in subsidiaries	1,406
Realization and decrease in shareholding percentage	(638)
Acquisition of newly-consolidated subsidiaries	3,364
Foreign currency translation adjustments	4,283
Balance as of December 31, 2006	104,273
Acquisition of additional interest in subsidiaries	4,206
Realization and decrease in shareholding percentage	(5,925)
Acquisition of newly-consolidated subsidiaries	10,281
Foreign currency translation adjustments	6,179
Balance as of December 31, 2007	119,014

Note 8 Other Assets, Net:

Comprised as follows:

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
A. Original amounts:		
Capitalized software development costs	101,604	89,780
Deferred expenses and others	15,793	14,032
Deferred tax asset	11,437	7,047
	128,834	110,859
Accumulated amortization:		
Capitalized software development costs	74,461	64,831
Deferred expenses and others	11,327	8,078
	85,788	72,909
Total	43,046	37,950

B. Amortized expenses totaled \$7.7 million, \$9.9 million and \$9 million for the years ended December 31, 2007, 2006 and 2005, respectively.

As for impairments of software development cost, see Note 1K.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 8 Other Assets, Net (Cont.):

C. Estimated deferred expenses and other intangible assets amortization for the years ended:

<u>December 31,</u>	<u>(U.S. \$ in thousands)</u>
2008	1,310
2009	901
2010	403
2011	403
2012 and thereafter	1,449

Note 9 Liabilities to Banks and Others:

A. Composition:

<u>December 31, 2007</u>	<u>Linkage basis</u>	<u>Long-term liabilities</u>	<u>Current maturities</u>	<u>Total long-term liabilities net of current maturities</u>	<u>Total long-term liabilities net of current maturities</u>
<u>Interest rate</u>			<u>December 31, 2007</u>		<u>December 31, 2006</u>
<u>%</u>			<u>(U.S. \$ in thousands)</u>		<u>(U.S. \$ in thousands)</u>
6.1-6.6	Dollar	56	-	56	95
4.3-5	CPI	552	552	-	492
5.5	NIS	31,866	9,118	22,748	58,106
2.2-5.7	Other	1,361	1,044	317	575
-	Unlinked	564	-	564	-
Total		34,399	10,714	23,685	59,268

B. Maturity Dates:

	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
	<u>(U.S. \$ in thousands)</u>	
First year (current maturities)	10,714	17,684
Second year	7,653	15,410
Third year	6,642	19,330
Fourth year	6,250	24,401

Fifth year	3,140	127
	<u> </u>	<u> </u>
Total	34,399	76,952
	<u> </u>	<u> </u>

C. For details of liens, guarantees and credit facilities see Note 12.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 10 Debentures:

Comprised as follows:

	Linkage	Interest rate	December 31,	
			2007	2006
			(U.S. \$ in thousands)	
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Debentures	CPI	5.2%	65,452	-
Convertible debenture:				
Par value	Dollar	6.0%	11,497	19,508
Embedded derivatives, net *)			1,366	1,135
			(966)	(**)
Deemed discount, net *)				(1,947)
			<u>77,349</u>	<u>18,696</u>
Less - debentures purchased by one of the Company's subsidiaries			(1,945)	(2,521)
Warrants (Series 1)			-	71
Less - current maturities of debentures			(3,524)	(4,450)
			<u>71,880</u>	<u>11,796</u>

*) Amortization of the deemed discount and the changes in the fair value of embedded derivatives charged to expenses were \$911 and \$254 thousand for 2007 and 2006, respectively.

**) The amounts were reclassified to conform the current year presentation.

The Company's subsidiary Sapiens' convertible debentures, warrants and options are traded only in the TASE. Any Common shares issued upon conversion of the Debentures (Series A) or exercise of the Warrants (Series 1) will be traded on both TASE and NASDAQ. The offering was

made to the public in Israel only in accordance with Israeli securities laws. It was not open to persons residing in the United States or to other U.S. persons (other than distributors). The securities offered have not been registered under the Securities Act of 1933, as amended, and may not be offered or sold in the United States absent registration under such Act or an applicable exemption from registration.

Pursuant to an evaluation of the terms of the agreement under the provisions of EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled In a Company's Own Stock (EITF 00-19), Sapiens has classified all the above derivative financial instruments issued in connection with issuance of the convertible debentures, Warrants and Options as liabilities.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 10 Debentures (cont.):

The conversion features and the floor rate to the dollar payments were evaluated under FAS 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), and EITF 00-19, and were determined under EITF 00-19 to have characteristics of liabilities and therefore derivative liabilities under FAS 133. Each reporting period these derivatives liabilities are marked to market with the non cash gain or loss recorded in the period. On December 31, 2007, the aggregate derivatives liabilities were \$1,143. The valuation of the embedded derivatives is determined by the Black and Scholes model and the Lattice model.

Amounts allocated to the Options (Series A) and the Warrants (Series 1) are accounted for as liabilities, in accordance with EITF 00-19, and are marked to market, based on their fair values in the TASE at each reporting date, against financial income (expense).

In August, 2006 Sapiens modified the terms of the first payment of the Debentures (Series A) that was due in December, 2006 as follows: (a) 50% of the first payment amount, approximately \$2.4 million, will be deferred to December 5, 2009 (the last day of payment of the principal on the debentures), and (b) with respect to other 50% of the first payment amount, Sapiens can choose from the following alternatives, in its sole discretion: (1) to convert such amount on December 5, 2006 into Sapiens's Common shares, at a conversion price per share of \$1.28, which reflects the average closing price for the 10 day period prior to July 17, 2006, or (2) to pay the approximately \$2.4 million amount to the debenture holders.

On December 5, 2006, an amount of approximately \$2.4 million was paid to the debenture holders.

The modification of the terms of the first payment of the Debentures (Series A) was accounted for in accordance with FAS 15 Accounting by Debtors and Creditors for Troubled Debt Restructurings. Accordingly, Sapiens calculated the new effective borrowing rate of the debt, which affected the amortization rate of the unamortized discount and unamortized issuance expenses as of the date of the restructuring.

In June 2007, Sapiens re-purchased an aggregate amount of NIS 15 millions nominal value, representing approximately \$3.5 million of the outstanding debentures that were retired and removed from circulation on the TASE.

On December 5, 2007, an amount of approximately \$4.4 million was paid to the debenture holders, representing the second payment of the Debentures (Series A).

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11 Employee Option Plans in Subsidiaries:

A. Certain public subsidiaries granted options to their employees to purchase shares in the respective companies.

The options were mainly granted during the years 1999-2007. In general, the options are exercisable 2-3 years after the date of grant and expire 7-10 years after grant. Most of the options were granted as part of plans that were adopted in accordance with the provisions of Section 102 of the Israeli Income Tax Ordinance, which stipulate, inter alia, that the subsidiaries will be able to claim the benefit that was charged to the employees as an expense for tax purposes, if and when the employees become liable for tax on the benefit mentioned above. For further information with respect to expenses relating to the benefit to the employees, and additional disclosure required by FAS 123R, see Note 1X.

B. The following table is a summary of the status of option plans in Magic as of December 31, 2007, 2006 and 2005:

	Year ended December 31, 2007		Year ended December 31, 2006		Year ended December 31, 2005	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
		\$		\$		\$
Options outstanding at the beginning of the year	2,352,632	2.52	3,061,216	2.62	2,513,237	2.95
Granted	1,773,332	1.78	62,000	1.69	820,028	1.70
Exercised	(218,205)	1.18	(253,346)	1.11	(80,604)	1.04
Forfeited	(234,231)	2.98	(517,238)	3.41	(191,445)	3.54
Outstanding at the end of the year	3,673,528	2.22	2,352,632	2.52	3,061,216	2.62
Exercisable at the end of the year	2,407,532	2.22	2,290,032	2.54	3,061,216	2.62
Weighted average fair value of options granted during the year *		1.31		1.7		1.1

* The fair value of each option granted is estimated on the date of grant, using the binomial model for the year 2007 and the Black-Scholes Option Valuation Model for the years 2005-2006 with the following weighted-average assumptions for each of the three years in the period ended December 31, 2007, 2006 and 2005: expected volatility of 51-73%, 64%, and 80%, respectively; risk-free interest rates of 3.46%-5.05%, 4.7% and 3.9% respectively; dividend yields of 0% for each year, and a weighted average expected life of the option of 2.48-3 years, 5 years and 5 years, respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11 Employee Option Plans in Subsidiaries (cont.):

B. (cont.):

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The options outstanding as of December 31, 2007, have been separated into ranges of exercise price categories, as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 2007	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2007	Weighted Average Exercise Price
		Years	\$		\$
0-1	494,887	8	0.25	494,887	0.25
1-2	1,542,956	7	1.56	1,034,956	1.36
2-3	878,000	9	2.37	120,004	2.37
3-4	402,470	6	3.8	402,470	3.81
4-5	193,004	6	4.12	193,004	4.12
5-6	128,000	6	5.95	128,000	5.95
6-7	711	2	6.14	711	6.14
10-11	24,500	2	10.16	24,500	10.16
18-19	9,000	2	18.79	9,000	18.79
	3,673,528			2,407,532	

- C. The following is a summary of the status of option plans in Matrix as of December 31, 2007 and 2006 and changes during the years then ended:

	Year ended December 31, 2007		Year ended December 31, 2006		Year ended December 31, 2005	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
		\$		\$		\$
Options outstanding at the beginning of the year	2,949,291	1.625	5,203,659	1.588	6,031,380	1.8
Granted	2,050,000	3.437	-	-	530,800	1.710
Exercised	(1,995,730)	1.68	(2,219,136)	1.54	(1,329,302)	1.434
Forfeited	(35,580)	1.564	(35,232)	1.524	(29,219)	1.410
Outstanding at the end of the year	2,967,981	3.08	2,949,291	1.625	5,203,659	1.588
Exercisable at the end of the year	1,217,981	1.72	2,949,291	1.625	5,180,707	1.588
Weighted average fair value of options granted during the year *		1.3		-		-

* The fair value of options granted in 2007 is estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted average assumptions used for grants: expected volatility: 24% - 25%; risk-free interest rate (in NIS terms) of 5.3%-5.5% and expected life: 3-3.5 years.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11 Employee Option Plans in Subsidiaries (cont.):

C. (cont.):

The following table summarizes information in respect of options outstanding as of December 31, 2007:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 2007	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2007	Weighted Average Exercise Price
\$		Years	\$		\$
1.584	479,141	2.55	1.584	479,141	1.584
1.811	738,840	3.34	1.811	738,840	1.811
4.027	1,750,000	4	4.027	-	-
	<u>2,967,981</u>			<u>1,217,981</u>	

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11 Employee Option Plans in Subsidiaries (cont.):

D. The following is a summary of the status of options plans in Sapiens as of December 31, 2007, 2006 and 2005 and changes during the years then ended:

Year ended December 31, 2007		Year ended December 31, 2006		Year ended December 31, 2005	
Number of options	Weighted Average Exercise Price	Number of options	Weighted Average Exercise Price	Number of options	Weighted Average Exercise Price

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	\$		\$		\$	
Options outstanding at the beginning of the year	**2,441,050	4.68	** 2,812,212	5.54	** 1,640,871	9.05
Changes during the year:						
Granted	691,000	2.39	20,000	1.33	1,608,200	2.61
Exercised	(29,569)	2.35	-	-	(19,500)	-
Forfeited	(276,581)	5.53	(391,162)	10.76	(417,359)	8.31
Options outstanding at the end of the year	**2,825,900	4.01	** 2,441,050	4.68	**2,812,212	5.54
Options exercisable at year-end	2,130,900	4.58	2,437,050	4.7	2,812,212	5.54
Weighted-average fair value of options granted during the year*		4.63		0.68		1.32

* The fair value of each option granted is estimated on the date of grant, using the Black-Scholes option-pricing model with the following weighted average assumption: Dividend yield of 0% for all years; expected volatility: 2007 - 89%, 2006 - 67%, 2005 - 83%, risk-free interest rate 2007 - 4.2%, 2006 - 6%, 2005 - 4.4% and expected life: 2007 - 6.25% years, 2006 - 6.25 year and 2005 - 6.9 years.

** Including 14,000, 59,000 and 62,300 options which were reprised to zero in 2005, as of December 2007, 2006 and 2005, respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 11 Employee Option Plans in Subsidiaries (cont.):

E. The following table summarizes information in respect of options outstanding as of December 31, 2007:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 2007	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2007	Weighted Average Exercise Price
\$		Years	\$		\$
0	14,000	0.83	0	14,000	0
1.14-1.86	458,000	7.22	1.65	325,000	1.74
2.00-2.63	540,450	8.05	2.31	228,450	2.31
3.00	1,250,000	8.17	3.00	1,000,000	3.00
3.28-3.75	30,900	2.34	3.73	30,900	3.73

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4.06-5.15	332,950	2.53	4.24	332,950	4.24
5.25-5.70	116,450	1.28	5.49	116,450	5.49
16.875-34.375	46,550	1.31	31.75	46,550	31.75
43.13-45.00	20,000	1.81	44.89	20,000	44.89
61.25-69.375	16,600	1.92	67.71	16,600	67.71
	<u>2,825,900</u>			<u>2,130,900</u>	

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 12 Commitments and Contingencies:

A. Commitments:

Some of the Company's subsidiaries have commitments to the Chief Scientist and to the Marketing Promotion Fund, to pay royalties at a rate of 3%-3.5% of the proceeds from the sale of software products which were developed with the assistance of the Chief Scientist and marketed with the assistance of the Marketing Promotion Fund. The amount of royalties is limited to 100%-150% of the amount received. The subsidiaries are only obliged to repay the grants received from the Office of the Chief Scientist if revenue is generated from the sale of the said software products.

The balance of the contingent liability in respect of the aforesaid, amounted to approximately \$10 million as of December 31, 2007.

B. Liens:

1. Some of the subsidiaries have liens on leased vehicles, leased equipment and other assets in favor of the leasing companies.
2. Some of the subsidiaries have given floating charges in favor of banks and other financial institutions.

C. Guarantees:

1. Subsidiaries have provided bank guarantees in the amount of approximately \$12.1 million as security for the performance of various contracts with customers. If the subsidiaries were to breach certain terms of such contracts, the customers could demand that the banks providing the guarantees pay amounts claimed to be due.
2. Subsidiaries have provided bank guarantees in the amount of \$1.3 million as security for rent to be paid for their offices. If the subsidiaries were to breach certain terms of their lease, the leaser could demand that the banks providing the guarantees pay amounts claimed to be due.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 12 Commitments and Contingencies (cont.):**D. Others:**

In connection with credit facilities of subsidiaries, these subsidiaries have entered into agreements with various banks. Accordingly, the subsidiaries committed, among other things:

- a. To maintain certain financial ratios.
- b. Not to grant a security interest in all or substantially all of their respective assets.

E. Legal Proceedings:

Lawsuits have been submitted against certain subsidiaries in the ordinary course of business. The group followed SFAS No. 5, and recorded provision where it was appropriate.

F. Lease Commitments:

The following are details of the future minimum lease commitments of office equipment, office space and motor vehicles under non-cancelable operating leases as of December 31, 2007:

	<u>U.S. \$ in thousands</u>
2008	19,637
2009	13,282
2010	6,801
2011	2,045
2012 and thereafter	341
	<u>42,106</u>

Rent expenses for the years ended December 31, 2007, 2006 and 2005, were approximately \$24 million, \$20 million and \$19 million, respectively.

Most of the building leases will expire by 2010.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 13 Shareholders Equity:

A. Share Capital Authorized, Issued and Outstanding:

	December 31, 2007			December 31, 2006		
	Authorized	Issued	Outstanding	Authorized	Issued	Outstanding
	NIS	NIS	NIS	NIS	NIS	NIS
Ordinary shares, NIS 1 par value each	25,000,000	13,224,780	13,200,000	25,000,000	13,224,780	13,200,000

1. Formula's shares are traded in the TASE and through ADSs, each representing one ordinary share of NIS 1 par value, quoted on the NASDAQ Global Market in the United States.
2. In 2002, Formula repurchased 324,780 of its ordinary shares in the open market for an aggregate of \$3.4 million. In 2003, Formula sold 300,000 of its ordinary shares for an aggregate of \$4.8 million.
3. In March 2005, Formula completed a private placement of 2,400,000 Formula shares for an aggregate consideration of \$33 million.

B. Details of Share Options Granted to Employees:

In November 2000, Formula's Board of Directors adopted an option plan pursuant to which Formula could grant options to employees of Formula to purchase up to a total of 300,000 ordinary shares.

In accordance with this plan, employees of Formula and its subsidiaries were granted, for no consideration, options to purchase 64,500 shares of Formula exercisable at \$30.8 per share, linked to the CPI. None of these options have been exercised and they expired in November 2005.

The following is a summary of the status of Formula's option plans as of December 31, 2005 and for the year then ended:

	Year ended December 31, 2005	
	Number of Options	Weighted Average Exercise Price \$
Outstanding options at the beginning of the year	64,500	30.8
Changes during the year:		
Expired and forfeited	(64,500)	-
Outstanding options at the end of the year	-	30.8
Exercisable options at the end of the year	-	30.8

C. On June 1, 2005, Formula declared and distributed a cash dividend in the amount of \$50.2 million.

See also note 2E.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14 Taxes on Income:

A. Tax Laws in Israel:

1. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereafter - the Law):

Some operations of certain subsidiaries have been granted the status of an Approved Enterprise under the Law. According to the provisions of the Law, the subsidiaries have elected the alternative benefits program and as such are entitled to receive certain tax benefits including accelerated depreciation of fixed assets in the investment programs as well as a full tax exemption on undistributed income that is derived from the portion of the Company and its subsidiaries facilities granted approved enterprise status, for a period of 10 years or a full tax exemption for a period of 6 years and reduced tax rates of 10%-25% (based on the percentage of foreign ownership in each taxable year) for an additional period of up to 4 years. The benefits commence with the date on which taxable income is first earned. The period of tax benefits detailed above is subject to a limit of the earlier of 12 years from the commencement of production or 14 years from receiving the approval.

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above Law, regulations published thereafter and the certificates of approval for the specific investments in an Approved Enterprise . In the event of failure to comply with these conditions, the benefits may be canceled and the subsidiary may be required to refund the amount of the benefits, in whole or in part, including interest.

The tax-exempt income attributable to an Approved Enterprise can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If this net retained tax-exempt income is distributed in a manner other than in the complete liquidation of the company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative tax benefits (currently 25% of the gross dividend).

The subsidiary does not anticipate paying dividends in the foreseeable future. Accordingly, no deferred tax liabilities have been provided on income attributable to the Company s Approved Enterprises .

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14 Taxes on Income (Cont.):

A. Tax Laws in Israel (cont.):

1. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereafter - the Law) (cont.):

Income from sources other than the Approved Enterprise during the period of benefits will be taxable at regular corporate tax rates.

An amendment to the Law, effective April 1, 2005 (the Amendment) changed certain provisions of the Law. The Amendment allowed tax benefits to be awarded pursuant to the Law so that companies no longer require Investment Center pre-approval in order to qualify for tax benefits. The subsidiaries existing Approved Enterprises will generally not be covered by the Amendment. As a result of the Amendment, where the benefits from tax-exempt income pursuant to the new regime, any such tax-exempt income generated will be subject to taxes on its distribution or upon liquidation of the subsidiary.

2. Measurement of results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985 (hereafter - the Inflationary Adjustments Law):

Results for tax purposes in Israel are measured and reflected in real terms in accordance with the change in the CPI. The consolidated financial statements are presented in dollars. The differences between the change in the Israeli CPI and in the NIS/dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, Accounting for Income Taxes (SFAS No. 109), the Company has not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

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

Some subsidiaries currently qualify as an Industrial Company as defined by this law, and as such are entitled to certain tax benefits including, inter alia, depreciation at increased rates as stipulated by regulations published under the Inflationary Adjustments Law and the right to deduct, for tax purposes, over a period of 3 years, expenses relating to public issue of shares. If realized, any tax benefit relating to issuance expenses is credited to capital surplus.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14 Taxes on Income (Cont.):

A. Tax Laws in Israel (cont.):

4. Tax Rates Applicable to Income in Israel:

On July 25, 2005, the Law for Amendment of the Income Tax Ordinance (Amendment No.147) became effective. Pursuant to this amendment, the income tax applicable to Israeli companies will be gradually reduced from 34% in 2005 to 25% in 2010 and henceforth.

5. Changes in the tax laws applicable to the Company:

During February 2008, the Knesset (Israeli parliament) passed an amendment to the Income Tax (Inflationary Adjustments) Law, 1985, which limits the scope of the law starting 2008 and thereafter. Starting 2008, the results for tax purposes will be measured in nominal values, excluding certain adjustments for changes in the Consumer Price Index carried out in the period up to December 31, 2007. The amended law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting 2008.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14 Taxes on Income (cont.):**B. Subsidiaries outside Israel:**

Subsidiaries that are not an Israeli resident are taxed in the countries in which they are resident, according to the tax laws in those countries.

C. Cumulative Tax Losses:

The Company and its subsidiaries have cumulative operating losses for tax purposes as of December 31, 2007 totaling approximately \$193.3 million, of which \$164.6 million is in respect of Companies in Israel (December 31, 2006 - \$190.8 million), and approximately \$28.7 million in respect of companies abroad (December 31, 2006 - \$31.5 million). The likelihood of the utilization of most of these losses in the future is low. Therefore, the company recorded a valuation allowance against the deferred taxes attributed to the operating losses carried forward.

D. Income Tax Assessments:

In 2007, Formula paid approximately \$250 thousand, as taxes for the years 2001-2004, after reaching an agreement with the Israeli tax authorities for those years.

E. Deferred Taxes:**1. Composition:**

	December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Net operating losses carried forward	55,164	67,969	54,156
Software development costs	266	239	71
Allowances and reserves	4,351	3,447	2,883
Adjustments to cash basis	(3,276)	-	-
	56,505	71,655	57,110
Valuation allowance	(45,635)	(62,486)	(50,297)
Total	10,870	9,169	6,813

Most of the valuation allowances for which the Company and its subsidiaries were provided, are against the deferred tax assets in respect of tax losses carry forward. As a result, most of the valuation allowance is long-term.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 14 Taxes on Income (cont.):

E. Deferred Taxes (cont.):

2. Presentation in balance sheets:

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
Stated in current assets	2,709	2,579
Stated in other assets	11,437	7,047
Stated in long term liabilities	(3,276)	(457)
Total (included in balance sheets)	10,870	9,169

F. Income before Taxes on Income:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Domestic	15,452	11,244	9,025
Foreign	9,262	(3,185)	(2,857)
Total	24,714	8,059	6,168

G. Taxes on Income Included in Statements of Operations:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Current taxes:			
In Israel	3,767	4,459	3,364

Abroad	692	645	596
	<u>4,459</u>	<u>5,104</u>	<u>3,960</u>
Taxes in Israel in respect of prior years	(468)	(44)	8
Deferred taxes, net	<u>(2,058)</u>	<u>(1,294)</u>	<u>679</u>
Total	<u>1,933</u>	<u>3,766</u>	<u>4,647</u>

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FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****Note 14 Taxes on Income (cont.):****H. Theoretical Tax:**

The following is reconciliation between the theoretical tax expense, assuming that all income was taxed at ordinary tax rates, and the actual income tax expense, as recorded in the statement of operations:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Income before taxes on income, as per the statement of continuing operations	24,714	8,057	6,168
Statutory tax rate in Israel	29%	31%	34%
Theoretical tax expense	<u>7,167</u>	<u>2,498</u>	<u>2,097</u>
Additional tax (tax savings) in respect of:			
Non-deductible expenses	705	1,218	978
Tax-exempt income, change in tax rate and reduced tax rates in companies which have approved enterprises	172	(556)	387
Losses (utilization of losses) and temporary differences for which deferred taxes were not recorded, net	(4,837)	(1,200)	(759)
Write off of deferred taxes and tax advances	885	2,494	1,797
Taxes in respect of previous years	(468)	(40)	145
Effect of the Inflationary Adjustments Law	(1,726)	(398)	(14)
Other	35	(250)	16

Taxes on income as per the statement of operations	(1,933)	(3,766)	(4,647)
Effective tax rate - in %	7.82%	46.7%	75.3%

I. Uncertain tax positions:

The Company and its subsidiaries adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) on January 1, 2007. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109 and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination.

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FORMULA SYSTEMS (1985) LTD.**(An Israeli Corporation)****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****14 Taxes on Income (cont.):****I. Uncertain tax positions (cont.):**

A reconciliation of the beginning and ending amount of total unrecognized tax benefits in the Company's subsidiaries, Magic and Sapiens, is as follows:

	<u>(U.S. \$ in thousands)</u>
Balance as of January 1, 2007	830
Increases related to current year tax positions	50
Settlements	(150)
Balance as of December 31, 2007	<u>730</u>

The impact of adopting FIN 48 is estimated in the amount of \$430 thousand on the Company's retained earnings and \$400 thousand on minority interest.

Note 15 Supplementary Financial Statement Information:**Balance Sheet:****A. Other Current Assets:****Composition:**

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
Government departments	5,500	5,179
Employees (1)	432	350
Prepaid expenses and advances to suppliers	8,313	5,223
Deferred taxes	2,709	2,579
Debtors from a sale of subsidiary	16,000	-
Other	1,868	4,251
Total	34,822	17,582

(1) Some of these balances are linked to the CPI, and bear interest at an annual rate of 4%.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 15 Supplementary Financial Statement Information (cont.):

B. Liabilities to Banks and Others:

Composition:

	December 31, 2007	Linkage basis	December 31,	
	Interest rate		2007	2006
	%		(U.S. \$ in thousands)	
Bank overdraft	5.6-6.6	Unlinked	1,175	5,166
Short-term bank loans	5.4-5.7	Unlinked	4,731	8,835
Short-term bank loans	6.4-7.2	Dollar	8,150	4,570
Short-term bank loans	5.5-6	Euro	1,479	3,184
Short-term bank loans	5.25	Other	705	975
Current maturities of long-term loans from banks			10,714	17,684

Total	26,954	40,414
--------------	--------	--------

C. Other Accounts Payable:**Composition:**

	December 31,	
	2007	2006
	(U.S. \$ in thousands)	
Employees and other wage and salary related liabilities	30,586	20,184
Government departments	8,810	9,889
Prepaid income and customer advances	20,908	19,350
Accrued expenses and other current liabilities	12,768	7,544
Total	73,072	56,967

D. Restructuring and Non-Recurring Costs:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Wages and related expenses	-	1,882	1,455
Expenses relating to closing of branches	-	1,029	-
Total	-	2,911	1,455

Restructuring expenses were recorded by consolidated companies and relate to the proprietary software products segment. These companies announced the adoption of a restructuring plan in order to reduce expenses and improve organizational and business efficiency.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 15 Supplementary Financial Statement Information (cont.):

E. Financial Expenses, Net:

Composition:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Financing income	6,898	6,310	14,116
Financing costs related to long-term credit	(6,795)	(6,446)	(6,792)
Financing costs related to short-term credit and others	(3,083)	(4,816)	(9,948)
Gain (loss) from marketable securities ,net.	(830)	292	565
Total	(3,810)	(4,660)	(2,059)

F. Other Expenses, Net:

Composition:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Gain on sale of fixed assets, net	7	9	16
Impairment of fixed assets	(137)	-	-
Impairment in value of cost based investment	(512)	(423)	-
Other	(108)	(688)	(357)
Total	(750)	(1,102)	(341)

G. Gain on Realization of Shareholdings, Net:

Composition:

Year ended December 31,		
2007	2006	2005
(U.S. \$ in thousands)		

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Loss from sale and decrease in shareholding percentage in Magic	(107)	(117)	(48)
Gain (loss) from sale and decrease in shareholding percentage in Matrix	(275)	(395)	3,357
Gain from sale and decrease in shareholding percentage in Tiltan	202	1,547	-
Capital gain (loss) from realization of Matrix One	-	2,485	(102)
Gain from sale and decrease in shareholding percentage in Sapiens	2,049	-	-
Gain on realization of other investments	170	204	(15)
Total	2,039	3,724	3,192

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 Supplementary Financial Statement Information (cont.):

H. Operating Segments:

The Company operates in two reportable business segments: IT Services and proprietary software solutions.

Software Services:

The following is a list of the Group's principal activities: applications development, systems integration, migration of IT platforms, IT consulting, e-services, outsourcing, conversion services, application and implementation of ERP & CRM systems, imported software products and a training school.

The Group provides these IT services across the full system development lifecycle, including the definition of business requirements, system analysis, technical specifications, coding, testing, training, implementation and maintenance. The Company performs its projects on-site or at its own facilities.

Proprietary Software Products:

The Group designs, develops and markets proprietary software solutions for sale in selected niche markets worldwide. The following is a list of the proprietary software solutions that are marketed by the Group:

Modernization solutions, Magic-technology, Magic eMerchant, solutions for law enforcement, application software for long term care industry, car rental solutions, solutions for banking and finance, solutions for telecommunications, CRM systems, Sapiens eMerge, re-engineering and AppBuilder and solutions for the insurance industry.

All of the Company's subsidiaries, including IT services companies and proprietary software solutions companies, recognize revenues from the delivery of software services, and most of them recognize revenues in both revenue categories. The Company's subsidiaries were classified into the following categories in accordance with the category in which most of the revenues of each subsidiary were earned.

The following is a list of the companies included in each operating segment, as of December 31, 2007:

Software Services:

Matrix IT Ltd.
NextSource Inc.

Proprietary Software Products:

Magic Software Enterprises Ltd.
Sapiens International Corporation N.V.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 Supplementary Financial Statement Information (cont.):

H. Operating Segments (cont.):

The Company evaluates the performances of each segment, software services and proprietary software products, based on operating income/loss. Headquarters and finance expenses are allocated proportionally between the segments:

	Software Services	Proprietary Software Products	Total
	(U.S. \$ in thousands)		
Revenues:			
2007	392,527	100,823	493,350
2006	322,629	96,883	419,512
2005	278,808	90,940	369,748
Inter-segment sales:			
2007	-	-	-
2006	2,690	15	2,705
2005	3,907	-	3,907
Operating income (loss):			
2007	25,473	1,762	27,235
2006	18,780	(8,683)	10,097
2005	18,909	(13,533)	5,376
Financial expenses:			
2007	(1,394)	(2,416)	(3,810)
2006	(2,464)	(2,196)	(4,660)
2005	(227)	(1,832)	(2,059)
Net income (loss):			
2007	11,386	1,075	12,461
2006	6,146	(6,638)	(492)
2005	8,006	(6,234)	1,772

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****NOTE 15 Supplementary Financial Statement Information (cont.):****H. Operating Segments (cont.):**

	Software Services	Proprietary Software Products	Total
	(U.S. \$ in thousands)		
Identifiable assets including goodwill:			
2007	382,574	151,429	534,003
2006	248,032	123,724	371,756
Identifiable liabilities:			
2007	159,611	43,584	203,195
2006	132,540	45,127	177,667
Depreciation and amortization:			
2007	4,043	5,160	9,203
2006	2,561	1,582	4,143
2005	3,917	10,403	14,320
Investments in segment assets:			
2007	2,726	959	3,685
2006	2,577	1,325	3,902
2005	2,581	6,760	9,341

Reconciliation between the data on sales and income of the operating segments and the data in the consolidated financial statements:

	2007	2006	2005
	(U.S. \$ in thousands)		
Revenues:			
Revenues as above	493,350	419,512	369,748

Less inter-segment transactions	-	(2,705)	(3,907)
	<u> </u>	<u> </u>	<u> </u>
Revenues as per statement of operations	493,350	416,807	365,841
	<u> </u>	<u> </u>	<u> </u>

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FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****NOTE 15 Supplementary Financial Statement Information (cont.):****H. Operating Segments (cont.):**

	<u>2007</u>	<u>2006</u>
	<u>(U.S. \$ in thousands)</u>	
Identifiable assets:		
Total assets of operating segments	534,003	371,756
Assets not identifiable to a particular segment	91,010	96,130
Elimination of inter-segment assets and other	(12,430)	(16,782)
	<u> </u>	<u> </u>
Total assets from continuing operation as per consolidated balance sheet	612,583	451,104
	<u> </u>	<u> </u>
Identifiable liabilities:		
Total liabilities of operating segments	203,195	177,667
Liabilities not identifiable to a particular segment	225,798	167,828
Elimination of inter-segment liabilities and other	(15,260)	(80)
	<u> </u>	<u> </u>
Total liabilities from continuing operation as per consolidated balance sheet	413,733	345,415
	<u> </u>	<u> </u>

I. Geographical Information:**1. The Company's Long-Lived Assets are as follows:**

<u>December 31,</u>	
<u>2007</u>	<u>2006</u>
<u> </u>	<u> </u>

	(U.S. \$ in thousands)	
	2007	2006
Israel	29,305	28,564
United States	1,045	222
Other	2,655	2,336
Total	33,005	31,122

2. Revenues:

Revenues classified by geographic area:

	Year ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Israel	319,444	264,293	228,812
International:			
United States	120,051	93,479	74,126
Other	53,855	59,035	62,903
Total	493,350	416,807	365,841

Classification was based on the location of the customers.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 Supplementary Financial Statement Information (cont.):

J. Earnings Per Share:

The following table presents the computation of basic and diluted net earnings per share of continuing operation:

	Year ended December 31,		
	2007	2006	2005

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(U.S. \$ in thousands)

Amount for basic earnings (loss) per share -income available to shareholders	12,461	(492)	1,766
Effect of dilutive securities of subsidiaries	(179)	-	-
Amount for diluted earnings (loss) per share -income available to shareholders	12,282	(492)	1,766
Weighted average shares outstanding			
Denominator for basic net earnings per share	13,200	13,200	12,800
Effect of dilutive securities	-	98	*)
Denominator for diluted net earnings per share	13,200	13,298	12,800
Basic net earnings (loss) per share of continuing operation	0.95	(0.04)	0.14
Diluted net earnings (loss) per share of continuing operation	0.93	(0.04)	0.14

*) Anti dilutive

Note 16 Discontinued operations:

- A. In December, 2006, the Company spun-off Formula Vision. Therefore, Formula Vision is no longer a subsidiary of the Company. The spin-off was affected by way of distributing the 36,696,000 Formula Vision shares owned by Formula (then representing approximately 57% of the outstanding Formula Vision shares) to Formula's shareholders on a pro-rata basis.

Formula Vision's shares were distributed at a ratio of 2.78 Formula Vision shares for each outstanding ordinary share held at the close of the trade on December 14, 2006, the record date, subject to withholding taxes. Formula Vision met the definition of a component under SFAS 144. Accordingly, the results of operations of Formula Vision have been classified as discontinued operations in the statement of operations of prior periods results. The Company followed EITF No. 87-24 and allocated interest on debt that is to be assumed by the buyer and is connected with the discontinued operation. The expenses allocated for the years 2006 and 2005 were \$9 million and \$15 million, respectively.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 16 Discontinued operations (Cont.):

- B. On June 20, 2007, the company completed the sale of its entire shareholding in BluePhoenix. BluePhoenix met the definition of a component under SFAS 144. Accordingly, the results of operations of BluePhoenix have been classified as discontinued operations in the statement of operations and prior periods results have been reclassified accordingly. In addition comparative data of the assets and liabilities attributed to the discontinued operations have been reclassified in the balance sheet.

C.

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In 2007, Magic disposed of two of its subsidiaries (AAOD and Magic Italy). Both subsidiaries met the definition of a component under SFAS 144. Accordingly, the results of operations of these subsidiaries and businesses and the gain resulting from the disposals have been classified as discontinued operations in the statement of operations and prior periods results have been reclassified accordingly. In addition, comparative data of the assets and liabilities attributed to the discontinued operations have been reclassified in the balance sheet.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 16 Discontinued operations (Cont.):

D. The following is the composition from discontinued operations (includes capital gain from realization):

	Year Ended December 31,		
	2007	2006	2005
	(U.S. \$ in thousands)		
Revenues	31,715	143,681	140,531
Cost of revenues	10,827	67,108	67,302
Gross profit	20,888	76,573	73,229
Research and development costs, net	7,107	21,870	16,334
Selling, general and administrative expenses	9,137	49,728	46,366
Restructuring and non-recurring costs	-	499	-
Operating income	4,644	4,476	10,529
Financial expenses, net	(2,006)	(7,821)	(7,148)
Gain on realization of shareholdings, net *,**	19,669	36,285	917
Other expenses (income) ,net	9,281	(14,698)	(478)
Income before taxes on income	31,588	18,242	3,820
Taxes on income (benefit)	136	(530)	554
	31,452	18,772	3,266
Equity in gains (losses) of affiliated companies, net	(857)	413	(3,173)
Minority interest in earnings of subsidiaries, net	(5,797)	(8,678)	(1,682)
Net income (loss)	24,798	10,507	(1,589)

* In November 2006, Formula Vision signed an agreement for effectively selling half of its holdings in Giga to an American investment company in consideration of \$11.2 million. Upon the completion of the transaction, Formula Vision held 24.58% of Giga's outstanding shares.

The gain from realization totaled \$10.6 million.

** In December 2006, Formula Vision engaged in an agreement with Karden Technologies Ltd. (henceforth: Karden), by which Karden acquires rights in a limited partnership held by Formula Vision to which Formula Vision's investments in 5 of its portfolio companies were transferred in consideration of \$21 million. The gain from realization totaled \$13.6 million.

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FORMULA SYSTEMS (1985) LTD.

(An Israeli Corporation)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 16 Discontinued operations (Cont.):

E. The breakdown of assets and liabilities attributed to discontinued operations as of December 31, 2006 is as follows:

	<u>December 31, 2006</u>
	<u>(U.S. \$ in thousands)</u>
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	12,854
Short-term investments	1,107
Trade receivables	28,027
Other current assets	4,718
	<u>46,706</u>
LONG-TERM INVESTMENTS, LOANS AND RECEIVABLES:	
Long-term trade receivables	1,390
	<u>4,052</u>
SEVERANCE PAY FUND	<u>4,052</u>
PROPERTY AND EQUIPMENT, NET	<u>2,512</u>
GOODWILL	<u>55,042</u>

OTHER ASSETS, NET	36,681
	<u> </u>
TOTAL ASSETS FROM DISCONTINUED OPERATIONS, NET	146,383
	<u> </u>
LIABILITIES AND SHAREHOLDERS EQUITY	
CURRENT LIABILITIES:	
Liabilities to banks and others	609
Trade payables	4,742
Other accounts payable	17,797
Debentures	4,482
	<u> </u>
	27,630
	<u> </u>
LONG-TERM LIABILITIES:	
Debentures	13,311
Liabilities to banks and others	20,027
Provisions for losses in formerly owned investee	1,971
Accrued severance pay	5,769
	<u> </u>
	41,078
	<u> </u>
MINORITY INTEREST	30,074
	<u> </u>
TOTAL LIABILITIES FROM DISCONTINUED OPERATIONS, NET	98,782
	<u> </u>

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FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****NOTE 17 Transactions with Related Parties:**

In March 2005, Formula completed a private placement of 2,400,000 Formula shares for an aggregate consideration of \$33 million. The shares were issued to FIMGold LP, an entity owned in equal shares by Dan Goldstein (the former chief executive officer and chairman of the board of Formula) and FIMI Opportunity Fund (see note 2G).

Note 18 Subsequent events:

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1. In March 2008, the Company's shareholders approved the adoption of Formula's 2008 Employee and Office Holders Share Option Plan, referred to as the plan. Pursuant to the plan, the company may grant from time to time to the company and its subsidiaries' employees and office holders (which are not Formula's controlling shareholders) options to purchase up to 400,000 ordinary shares of Formula. The plan is administered by the Company's board of directors or by an option committee to be appointed by the board. The plan provides that options may be granted, from time to time, to such grantees to be determined by the board or the option committee, at an exercise price and under such terms to be determined at their sole and absolute discretion. Options may be granted under the plan through January 2018.

Of the options available for grant under the plan, the company granted in March 2008, options to purchase 198,000 ordinary shares to the Company's chief executive officer and director, each exercisable at an exercise price of \$16.35 (NIS 60).

2. In April 2008, the Company distributed a cash dividend of approximately \$0.76 per share to its shareholders. The aggregate amount distributed by the company was approximately \$10 million.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

SAPIENS INTERNATIONAL CORPORATION N.V.

We have audited the accompanying consolidated balance sheets of Sapiens International Corporation N.V. and its subsidiaries (the Company) as of December 31, 2006 and 2007 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, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sapiens International Corporation N.V. and its subsidiaries as of December 31, 2006 and 2007 and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel
June 25, 2008

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors of

MAGIC SOFTWARE ENTERPRISES LTD.

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We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. (the Company) and its subsidiaries as of December 31, 2006 and 2007, 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, 2007. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect total assets of 18% and 19% as of December 31, 2006 and 2007, respectively, and total revenues of 18%, 33% and 29% for each of the three years in the period ended December 31, 2007 of the related consolidated totals. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those subsidiaries, is based solely on the reports of the other auditors.

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

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2006 and 2007, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2007 the Company adopted FASB interpretation No. 48 Accounting for Uncertainty in Income Taxes - An Interpretation of FASB No. 109, effective January 1, 2007. As discussed in Note 2 to the consolidated financial statements, the Company adopted the provision of Statement of Financial Accounting Standard No. 123(R), Share-Based Payment.

As discussed in Note 2 to the consolidated financial statements, on December 31, 2007, the Company initially applied the provisions of Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, and recorded a cumulative effect adjustment to beginning accumulated deficit at January 1, 2006 and adjustments to property and equipment as of December 31, 2005.

Tel-Aviv, Israel
May 15, 2008

KOST FORER GABBAY & KASIERER
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To the Board of Directors and Shareholders of
HERMES LOGISTICS TECHNOLOGIES LIMITED

We have audited the accompanying balance sheet of HERMES LOGISTICS TECHNOLOGIES LIMITED. (the Company) as of December 31, 2007 and 2006, and the related statements operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and at December 31, 2006 and 2007, and the related statements operations, changes in shareholders' equity for each of the two years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

LEVY COHEN & CO

Registered Auditors

January 12, 2008

Registered Auditors

37 Broadhurst Gardens, London NW6 3QT

Tel: 020 - 7624 2251 Fax: 020 - 7372 2328

E - mail: lc@levy-cohen.co.uk

To the Board of Directors and Shareholders of
MAGIC SOFTWARE ENTERPRISES (UK) LIMITED

We have audited the accompanying balance sheet of MAGIC SOFTWARE ENTERPRISES (UK) LIMITED. (the Company) as of December 31, 2007 and 2006, and the related statements operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and at December 31, 2006 and 2007, and the related statements operations, changes in shareholders' equity for each of the two years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

LEVY COHEN & CO

Registered Auditors

January 12, 2008

REPORT OF INDEPENDENT AUDITORS

**To the Board of Directors and Shareholders of
Magic (Onyx) Magyarország Szoftverház Kft.**

We have audited the accompanying balance sheet of Magic (Onyx) Magyarország Szoftverház Kft. (the Company) as of December 31, 2007 and 2006, and the related statements operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an

opinion on these financial statements based on our audit.

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

In our opinion, based on our audits and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and at December 31, 2006 and 2007, and the related statements operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

Budapest May 9, 2008

January 31, 2008

Kost Forer Gabbay & Kasierer

Certified Public Accountants

3 Aminadav St.

Tel-Aviv, ISRAEL

Gentlemen,

Re: Magic Software Japan K.K. (hereinafter - the Company)

In connection with our audit of the financial statements of the Company for the year ended December 31, 2007, a subsidiary of Magic Software Enterprises Ltd. whose financial statements are audited by you, we confirm that:

We are independent with respect to the Company and Magic Software Enterprises Ltd. and other affiliates, under the standards of the Public Company Accounting Oversight Board (United States) and the Securities and Exchange Commission.

We are aware that the financial statements of the Company, which we have audited, are to be included in the consolidated financial statements of Magic Software Enterprises Ltd. on which Ernst & Young will report and that your report will rely on and refer to our report.

We are familiar with U.S. generally accepted accounting principles and with the standards of the Public Company Accounting Oversight Board (United States) and we conducted our audit and reported in accordance with them.

We have knowledge of the relevant financial reporting requirements for the statements and schedules to be filed with the Securities and Exchange Commission and the financial statements of the Company comply with them in all material respects.

We will make a review and inform you of matters affecting the elimination of intercompany transactions and accounts based upon related party information that you will furnish us.

We will provide you, upon request, access to audit documentation supporting the work performed.

We will have complete and final documentation to support our report no more than 45 days after the report release date or the completion of our work. If we have any issues meeting this requirement, we will bring the issues to your attention as soon as they are known.

Very truly yours,

KDA Audit Corporation

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

Brescia, 14th February 2008

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders of
MAGIC SOFTWARE ENTERPRISES ITALY SRL

We have audited the accompanying balance sheet of MSE Italy Srl. (the Company) as of December 31, 2007 and 2006, and the related statements operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and at December 31, 2006 and 2007, and the related statements operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

Yours Truly

Federico Pozzi

25125 Brescia, Italy Via Brozzoni, 9 Tel. +39.30.223262 r.a. Fax +39.30.224054 E-mail: info@studionassini.it
web site: <http://www.studionassini.it>

ARGENTINA, AUSTRALIA (NEW SOUTH WALES, VICTORIA), AUSTRIA, BELGIUM, CANADA (BRITISH COLUMBIA, ONTARIO, QUEBEC), CHINA, CYPRUS, DENMARK, EGYPT, EL SALVADOR, ENGLAND, FINLAND, FRANCE, GERMANY, GUATEMALA, HONG KONG, INDIA, INDONESIA, IRELAND, ITALY, JAPAN, JORDAN, KENYA, KOREA, KUWAIT, LEBANON, LITHUANIA, LUXEMBOURG, MALAYSIA, MALTA, MAURITIUS, MEXICO, NETHERLANDS, NORTHERN IRELAND, OMAN, PAKISTAN, PALESTINE, PHILIPPINES, POLAND, PORTUGAL, RUSSIA, SAUDI ARABIA, SCOTLAND, SINGAPORE, SOUTH AFRICA, SPAIN, SWITZERLAND, THAILAND, TURKEY, UNITED ARAB EMIRATES, USA (ALABAMA, ARIZONA, CALIFORNIA, ILLINOIS, NEW JERSEY, NEW YORK, NORTH CAROLINA, OKLAHOMA, PENNSYLVANIA, TEXAS, UTAH, WASHINGTON), VIETNAM, YEMEN.
C.F.e P.IVA 01957960170

Magic Benelux B.V.

Auditor's report

Report on the financial statements

We have audited the accompanying financial statements for the year ended December 31, 2007 of Magic Benelux B.V., Houten, which comprise the balance sheet as at December 31, 2007 the profit and loss account for the year then ended and the notes.

Management's responsibility

Management is responsible for the preparation and fair presentation of the financial statements and for the preparation of the management board report, both in conformity with U.S. generally accepted accounting principles. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with Dutch law. This law requires that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Magic Benelux B.V.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Magic Benelux B.V. as at December 31, 2007, and of its result for the year then ended in conformity with U.S. generally accepted accounting principles.

Dordrecht, February 5, 2008

Verstegen accountants en adviseurs

Drs. L.K. Hoogendoorn RA MGA

SIGNATURES

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

FORMULA SYSTEMS (1985) LTD.

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

June 30, 2008
Date

EXHIBIT INDEX

Exhibit No.

- | | |
|-------------|--|
| 1.1 | Memorandum of Association (1) |
| 1.2 | Articles of Association as amended on December 28, 2005 (2) |
| 4.1 | Form of Letter of Indemnification, dated December 28, 2005 (2) |
| 4.2 | International Securities Purchase Agreement dated June 15, 2007 between the Registrant and each of the purchasers identified on the signature pages of the agreement (3) |
| 8 | List of Subsidiaries |
| 12.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 12.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 13.1 | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 13.2 | Certification of the Chief Financial Officer pursuant to Section. 906 of the Sarbanes-Oxley Act of 2002 |

(1) Incorporated by reference to the Registration Statement on Form F-1 (File No. 333-8858).

(2) Incorporated by reference to the Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 29, 2006.

(3) Incorporated by reference to the Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 29, 2007.
