

FORMULA SYSTEMS (1985) LTD
Form 20-F/A
June 14, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 20-F/A
Amendment No. 1

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, 2010

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: 000-29442

FORMULA SYSTEMS (1985) LTD.
(Exact Name of Registrant as Specified in Its Charter)

Israel
(Jurisdiction of Incorporation or Organization)

5 Haplada Street, Or Yehuda 60218, Israel
(Address of Principal Executive Offices)

Guy Bernstein, CEO, 5 Haplada Street, Or Yehuda 60218, Israel
Tel: 972 3 5389487, Fax: 972 3 5389645
(Name, Telephone, E-mail and/or Facsimile Number and Address of Company Contact Person)

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

Title of Each Class	Name of Each Exchange On Which Registered
Ordinary Shares, NIS 1 par value	Tel Aviv Stock Exchange
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, 2010, the registrant had 13,596,000 outstanding ordinary shares, NIS 1 par value, of which 1,035,593 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

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

Yes No

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

Large accelerated filer <input type="radio"/>	Accelerated filer <input type="radio"/>
<input checked="" type="radio"/>	Non-accelerated filer <input type="radio"/>

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

U.S. GAAP x

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

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 o Item 18 o

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 o No x

3

EXPLANATORY NOTE

This Amendment No. 1 (the “Amendment”) to the Annual Report on Form 20-F for the year ended December 31, 2010, filed on March 18, 2011 with the Securities and Exchange Commission (the “Original Report”), is being filed by Formula Systems (1985) Ltd. (“Formula” or the “Company”), to amend the Original Report for the sole purposes of: (i) revising the disclosure in paragraph (a)(1)(i) under Item 16F (“Change in Registrant’s Certifying Accountant”) to re-characterize the cause of the change in the Company’s principal accountant effective as of the second quarter of 2010 as a dismissal of the Company’s former principal accountant (the “Former Accountant”); (ii) filing once again, as an exhibit to the Amendment (as Exhibit 15.8 to the Amendment, in replacement of Exhibit 15.7 to the Original Report), a letter from the Former Accountant in which it expresses agreement with the revised disclosure set forth in Item 16F(a) of the Amendment (i.e., including the revised statement concerning the dismissal of the Former Accountant described in clause (i) immediately above); (iii) adding to the Company’s current auditor’s report on the Company’s consolidated financial statements and the other reports of auditors of the Company’s subsidiaries that were filed pursuant to Item 18 of Form 20-F the report of the Former Accountant on the Company’s consolidated financial statements as of December 31, 2009 and for the two year period then ended (the “Former Accountant Audit Report”), in accordance with Rule 2-05 of Regulation S-X promulgated by the Securities and Exchange Commission; and (iv) filing, as a new exhibit (Exhibit 15.7 to the Amendment) the consent of the Former Accountant to the incorporation by reference of the Former Accountant Audit Report (as included in the Amendment) in the Company’s Registration Statement on Form S-8 (No. 333-156686).

Other than as set forth herein, this Amendment does not, and does not purport to, amend or restate any other information contained in the Original Report, nor does this Amendment reflect any events that have occurred after the Original Report was filed. The filing of this Amendment shall not be deemed an admission that the Original Report, when filed, included any untrue statement of a material fact or omitted to state a material fact necessary to make a statement not misleading.

Capitalized terms appearing in this Amendment which are not otherwise defined shall have the respective meanings assigned to them in the Original Report.

ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT

(a)(1)(i) Effective as of the second quarter of 2010, Ziv Haft was dismissed as our independent auditor, following its audit of our consolidated financial statements for the year ended December 31, 2009.

(ii) The reports of Ziv Haft on our financial statements for each of the two fiscal years ended December 31, 2009 and 2008 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope, or accounting principles.

(iii) In keeping with the requirements of the Companies Law, our decision to change accountants was recommended and/or approved by each of (a) the audit committee of our board of directors, (b) our board of directors and (c) our shareholders. Pursuant to the Companies Law, the opinion of our audit committee with regard to the non-renewal of the services of Ziv Haft was presented at our 2010 annual general meeting of shareholders held on August 11, 2010, which opinion was formulated after Ziv Haft was given an opportunity to present its position to our audit committee.

(iv) During each of the two fiscal years ended December 31, 2009 and 2008 and through the interim period preceding the non-continuation of Ziv Haft's services, there were no disagreements with Ziv Haft on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which, if not resolved to the satisfaction of Ziv Haft, would have caused Ziv Haft to make reference to the matter in connection with its reports.

(v) During each of the two fiscal years ended December 31, 2009 and 2008 and through the interim period preceding the non-continuation of Ziv Haft's services, none of the reportable events listed in paragraphs (a)(1)(v)(A) through (D) of Item 16F of the SEC's Form 20-F occurred.

(2) Based on the recommendation and/or approval by each of (a) the audit committee of our board of directors, (b) our board of directors and (c) our shareholders (shareholder approval was obtained at our 2010 Annual General Meeting of shareholders held on August 11, 2010), Kost Forer was engaged as our new independent auditor for the fiscal year ending December 31, 2010, effective as of the start of our 2nd fiscal quarter of 2010. Prior to its engagement, we did not consult with Kost Forer regarding matters or events set forth in paragraphs (a)(2)(i) or (a)(2)(ii) of Item 16F of the SEC's Form 20-F.

(3) We have provided Ziv Haft with a copy of the disclosures that we have made in response to this Item 16F(a) and requested that Ziv Haft furnish us with a letter addressed to the SEC stating whether it agrees with the above statements made by us in response to this Item 16F(a) and, if not, stating the respects in which it does not agree with such statements. Ziv Haft's response letter is filed as Exhibit 15.8 to this Amendment No. 1 to our annual report on Form 20-F.

ITEM 18. FINANCIAL STATEMENTS

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

Report of Independent Registered Public Accounting Firm	F-1
Consolidated Balance Sheets at December 31, 2010 and 2009	F-4
Consolidated Statements of Operations for the Years Ended December 31, 2010, 2009 and 2008	F-6
Consolidated Statements of Changes in Shareholders' Equity for the Years Ended December 31, 2010, 2009 and 2008	F-7
Consolidated Statements of Cash Flows for the Years Ended December 31, 2010, 2009 and 2008	F-8
Notes to Consolidated Financial Statements	F-13

In addition, the reports of (i) Ziv Haft, which audited our consolidated financial statements as of December 31, 2009 and for the two fiscal years then ended, and (ii) the independent accounting firms that have audited the financial statements of certain of our subsidiaries for the fiscal year ended, and as of, December 31, 2010, whose audits are in each case referenced by our independent registered public accounting firm in its report on our consolidated financial statements included herein, have also been filed as part of this annual report (as amended).

ITEM 19. EXHIBITS

Exhibit
No.

- 1.1 Memorandum of Association (1)
- 1.2 Articles of Association as amended on December 28, 2005 (2)
- 2.1 Depositary Agreement by and among Formula Systems (1985) Ltd., Bank of New York Mellon and the holders of the American Depositary Shares of Formula Systems (1985) Ltd. (1)
- 4.1 Form of Letter of Indemnification, dated December 28, 2005 (2)
- 4.2 English translation of Formula Systems (1985) Ltd. Employees and Office Holders Share Option Plan (2008)(3)
- 8 List of Subsidiaries*
- 12.1 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Exchange Act**
- 13.1 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b)/Rule 15d-14(b) under the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
- 15.1 Consent of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global *
- 15.2 Consent of Levy Cohen and Co. *
- 15.3 Consent of Levy Cohen and Co. *
- 15.4 Consent of Versteegen accountants en adviseurs*
- 15.5 Consent of KDA Audit Corporation*
- 15.6 Consent of Maria Negyessy*
- 15.7 Consent of Ziv Haft, registered certified public accountants (Isr.) BDO member firm**
- 15.8 Letter dated June 14, 2011 of Ziv Haft, registered certified public accountants (Isr.) BDO member firm, required to be filed under Item 16F(a)(3) of this annual report**

* Previously filed, as an exhibit to the original annual report on Form 20-F for the 2010 fiscal year filed by the registrant with the Securities and Exchange Commission on March 18, 2011.

* * Filed herewith.

(1) Incorporated by reference to the Registration Statement on Form F-1 (File No. 333-8858) filed with respect to the registrant's American Depositary Shares.

- (2) Incorporated by reference to the annual report on Form 20-F for the 2005 fiscal year filed by the registrant with the Securities and Exchange Commission on June 29, 2006.
- (3) Incorporated by reference to the annual report on Form 20-F for the 2008 fiscal year filed by the registrant with the Securities and Exchange Commission on April 27, 2009.

SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Amendment No. 1 to its annual report on its behalf.

FORMULA SYSTEMS (1985) LTD.

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

June 14, 2011
Date

EXHIBIT INDEX

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FORMULA SYSTEMS (1985) LTD.

(An Israeli corporation)

2010 Annual Report

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2010

U.S. DOLLARS IN THOUSANDS

INDEX

	Page
Report Of Independent Registered Public Accounting Firms:	F-2 - F-4
Consolidated Financial Statements:	
Balance Sheets	F-5 - F-6
Statements of Income	F-7
Statements of Changes in Shareholders' Equity	F-8 - F-9
Statements of Cash Flows	F-10 - F-13
Notes to Financial Statements	F-14 - F-63

Kost Forer Gabbay & Kasierer
3 Aminadav St.
Tel-Aviv 67067, Israel

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

Report of Independent Registered Public Accounting Firm
To the Board of Directors and Shareholders of
FORMULA SYSTEMS (1985) LTD.

We have audited the accompanying consolidated balance sheet of Formula Systems (1985) Ltd. and its subsidiaries (the "Company") as of December 31, 2010 and the related consolidated statements of income, changes in shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of certain subsidiaries, which statements reflect total assets of 2% as of December 31, 2010, and total revenues of 4%, for the year then ended, 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.

The financial statements of the Company as of December 31, 2009 and for each of the two years in the period ended December 31, 2009, were audited by another auditor who expressed an unqualified opinion on those financial statements in his report dated April 29, 2010.

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

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2010 and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

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, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 18, 2011 expressed an unqualified opinion thereon.

Tel-Aviv, Israel
March 18, 2011

/s/ Kost, Forer, Gabbay & Kasierer
KOST, FORER, GABBAY & KASIERER
A Member of Ernst & Young Global

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3 Aminadav St.
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

FORMULA SYSTEMS (1985) LTD.

We have audited Formula Systems (1985) Ltd's ("Formula" or "the Company") internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Formula's management is responsible for maintaining effective internal control over financial reporting in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

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As indicated in the accompanying Management's Report on Internal Control over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Fusion Solutions LLC, which is included in the 2010 consolidated financial statements of Formula Systems (1985) Ltd. and which constituted 1.7% of consolidated total assets and 0.7% of consolidated shareholders' equity as of December 31, 2010, and 6.2% of consolidated revenues and 6.8% of consolidated net income from continuing operations for the year then ended. Our audit of internal control over financial reporting of Formula Systems (1985) Ltd. also did not include an evaluation of the internal control over financial reporting of Fusion Solutions LLC.

In our opinion, Formula maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, 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 Formula and its subsidiaries as of December 31, 2010 and the related consolidated statements of operations, changes in equity and cash flows for the year then ended and our report dated March 18, 2011 expressed an unqualified opinion thereon.

The financial statements of the Company as of December 31, 2009 and for each of the two years in the period ended December 31, 2009, were audited by another auditor who expressed an unqualified opinion on those financial statements in his report dated April 29, 2010.

/s/ Kost, Forer, Gabbay & Kasierer
KOST, FORER, GABBAY &
KASIERER
A Member of Ernst & Young Global

Tel-Aviv, Israel
March 18, 2011

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2010	2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	110,508	100,205
Marketable securities (Note 4)	38,170	44,171
Short-term deposits	24	13,838
Trade receivables (net of allowances for doubtful debts of \$ 3,781 and \$ 4,750 as of December 31, 2010 and 2009, respectively)	154,366	130,237
Other current assets (Note 16a)	23,140	22,448
Inventories	5,601	2,439
Total assets attributed to discontinued operations	-	27
	331,809	313,365
LONG-TERM INVESTMENTS:		
Marketable Securities (Note 4)	2,828	7,381
Deferred taxes (Note 15b)	13,135	9,499
Investments in affiliated company (Note 6)	3,209	3,710
Prepaid expenses and other assets	5,493	3,423
	24,665	24,013
SEVERANCE PAY FUND	55,286	44,131
PROPERTY, PLANTS AND EQUIPMENT, NET (Note 7)	12,411	9,989
NET INTANGIBLE ASSETS (Note 9)	33,101	27,534
GOODWILL (Note 8)	166,495	147,407
	623,767	566,439

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2010	2009
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Liabilities to banks (Note 16b)	6,684	10,055
Trade payables	53,177	43,777
Deferred revenue	26,845	25,206
Employees and payroll accrual	40,704	32,029
Other accounts payable (Note 16c)	30,693	26,994
Dividend payable	-	6,694
Liability in respect of business combinations	3,963	210
Debentures (Note 11)	15,927	14,639
Liabilities attributed to discontinued operations	-	314
	177,993	159,918
LONG-TERM LIABILITIES:		
Debentures (Note 11)	31,854	43,918
Deferred taxes (Note 15e)	2,654	2,207
Customer advances	3,520	1,116
Liabilities to banks and others (Note 10)	3,154	8,556
Liability in respect of business combinations	4,758	1,517
Accrued severance pay	65,450	53,893
	111,390	111,207
COMMITMENTS AND CONTINGENCIES (Note 13)		
SHAREHOLDERS' EQUITY (Note 14):		
Formula shareholders' equity:		
Share capital - ordinary shares of NIS 1 par value		
Authorized - December 31, 2010 and 2009 - 25,000,000 shares; Issued: December 31, 2010 - 13,620,780 and 2009 - 13,224,780 shares)	3,807	3,736
Additional paid-in capital	136,222	131,631
Retained earnings	58,441	60,048
Other accumulated comprehensive loss	(596)	(7,115)
Treasury shares (24,780 shares as of December 31, 2010 and 2009)	(259)	(259)
Total Formula shareholders' equity	197,615	188,041
Non-controlling interests	136,769	107,273
TOTAL SHAREHOLDERS' EQUITY	334,384	295,314

623,767

566,439

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

F-6

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF INCOME

U.S. dollars in thousands, except per share amounts

	2010	Year ended December 31, 2009	2008
Revenues (Note 16g)			
Proprietary software products	98,498	88,815	92,560
Software services	451,196	380,575	410,683
Total revenues	549,694	469,390	503,243
Cost of revenues			
Proprietary software products	46,297	43,057	43,246
Software services	366,166	309,226	330,529
Total cost of revenues	412,463	352,283	373,775
Gross profit	137,231	117,107	129,468
Research and development costs, net	5,503	4,430	6,564
Selling, general and administrative expenses	84,510	77,322	90,451
Other expenses (income), net	231	(1,668)	580
Operating income	46,987	37,023	31,873
Financial expenses, net (Note 16d)	(4,371)	(231)	(5,908)
Losses on realization of investments, net	-	-	(337)
Income before taxes on income	42,616	36,792	25,628
Taxes on income (Note 15)	(6,544)	(8,305)	(3,279)
	36,072	28,487	22,349
Equity in losses of affiliated company, net	(1,070)	(335)	(216)
Income from continuing operation	35,002	28,152	22,133
Net income from discontinued operations (Note 17d)	-	4,878	555
Net income	35,002	33,030	22,688
Net income Attributable to non-controlling interests	16,623	13,954	10,819
Net income attributable to Formula's shareholders	18,379	19,076	11,869
Amount attributable to Formula's shareholders			
Income from continuing operation	18,379	14,198	11,314

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Income from discontinued operation	-	4,878	555
	18,379	19,076	11,869
Earnings per share generated from continuing operation:			
Basic	1.37	1.08	0.84
Diluted	1.36	1.04	0.84
Earnings per share generated from discontinued operations:			
Basic	-	0.37	0.04
Diluted	-	0.36	0.04
Total earnings per share:			
Basic	1.37	1.44	0.88
Diluted	1.36	1.40	0.88
Weighted average number of shares outstanding in thousands (Note 16h):			
Basic	13,382	13,200	13,200
Diluted	13,523	13,564	13,200

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

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

	Share Number	Capital Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Cost of treasury shares	Total Formula ' shareholders' Equity	Non- controlling interests
Balance as of January 1, 2008	13,200,000	3,736	132,545	69,229	(6,863)	(259)	198,388	107,915
Changes during 2008:								
Net Income	-	-	-	11,869	-	-	11,869	10,819
Unrealized loss from available - for-sale securities, net	-	-	-	-	(1,123)	-	(1,123)	(20)
Adjustment for other than temporary impairment on marketable securities	-	-	-	-	27	-	27	20
Foreign Currency translation adjustments	-	-	-	-	859	-	859	1,164
Total comprehensive income	-	-	-	-	-	-	11,632	
Gain from issuance of shares to third party in a development stage entity	-	-	43	-	-	-	43	43
Stock Based Compensation expenses	-	-	-	-	-	-	-	1,161
Changes in non-controlling interests due to holding changes	-	-	-	-	-	-	-	(9,483)
Exercise of employees stock options	-	-	-	-	-	-	-	1,426
Dividend to Formulas" shareholders and to non-controlling interests in subsidiaries	-	-	-	(40,126)	-	-	(40,126)	(5,612)
Balance as of December 31, 2008	13,200,000	3,736	132,588	40,972	(7,100)	(259)	169,937	107,433
Changes during 2009:								
Net Income	-	-	-	19,076	-	-	19,076	13,954
	-	-	-	-	3	-	3	2

Unrealized gain from derivative instruments, net								
Unrealized gain (loss) from available - for-sale securities, net	-	-	-	-	(66)	-	(66)	74
Other temporary impairment					(250)		(250)	
Foreign Currency translation adjustments	-	-	-	-	298	-	298	413
Total comprehensive income							19,061	
Stock Based Compensation expenses	-	-	308	-	-	-	308	1,333
Non-controlling interests changes due to holding changes including exercise of employees stock options	-	-	(1,265)	-	-	-	(1,265)	(842)
Dividend to non-controlling interests in subsidiaries	-	-	-	-	-	-	-	(15,094)
Balance as of December 31, 2009	13,200,000	3,736	131,631	60,048	(7,115)	(259)	188,041	107,273

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

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

	Share Number	Capital Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Cost of treasury shares	Total Formula ' shareholders' Equity	Non- controlling interests
Changes during 2010:								
Net Income	-	-	-	18,379	-	-	18,379	16,623
Unrealized gain from derivative instruments, net	-	-	-	-	4	-	4	3
Unrealized gain (loss) from available - for-sale securities, net	-	-	-	-	180	-	180	(21)
Realized gain from available-for-sale securities	-	-	-	-	250	-	250	
Foreign Currency translation adjustments	-	-	-	-	6,085	-	6,085	4,793
Total comprehensive income					6,519		24,898	
Stock Based Compensation expenses	-	-	458	-	-	-	458	1,006
Exercise of employees stock options	396,000	71	(71)	-	-	-	-	-
Non controlling interests changes due to holding changes including exercise of employees stock options			6,258	-	-	-	6,258	16,068
Acquisition of non-controlling interests			(2,054)				(2,054)	(1,711)
Dividend to Formula's shareholders and to non-controlling interests in subsidiaries	-	-	-	(19,986)	-		(19,986)	(7,265)
Balance as of December 31, 2010	13,596,000	3,807	136,222	58,441	(596)	(259)	197,615	136,769
		Year ended December 31,						
	2010	2009		2008				

Accumulated unrealized loss from available - for-sale securities	(954)	(1,384)	(1,068)
Accumulated currency translation adjustments	351	(5,734)	(6,032)
Accumulated Unrealized gain from derivative instruments	7	3	-
Accumulated other comprehensive income (loss)	596	(7,115)	(7,100)

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

F-9

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	2010	Year ended December 31, 2009	2008
Cash flows from operating activities:			
Net income	35,002	33,030	22,688
Adjustments to reconcile net income to net cash provided by operating activities:			
Impairment and write down of other investments and fixed assets	-	59	502
Impairment of available for sale marketable securities	292	143	-
Equity in losses of affiliated company	1,070	335	216
Depreciation and amortization	15,451	14,605	13,082
Amortization of convertible debt discount, increase in value and current interest	1,728	-	-
Increase (decrease) in accrued severance pay, net	(148)	(1,618)	4,984
Gain from sale of operation and subsidiaries	(146)	(4,389)	-
Loss (gain) from sale of property, plants and equipment	1	(2,219)	(341)
Loss (gain) on realization of shareholdings and operations	-	-	337
Stock-based compensation expenses	1,464	1,641	1,505
Changes in financial liabilities, net	325	(202)	4,950
Loss (gain) from repurchase of convertible debt, net	-	2	(218)
Changes in value of long term loans and deposits, net	64	(210)	(129)
Changes in deferred taxes, net	(3,355)	665	(1,881)
Change in liability in respect of business combinations	265	458	(558)
Loss (gain) from sale and decrease (increase) in value of marketable securities classified as trading	630	(2,609)	1,481
Proceeds from derivatives	2,423	-	-
Changes in operating assets and liabilities:			
Decrease (increase) in inventories	(3,007)	340	446
Decrease (increase) in trade receivables	(9,500)	13,057	(8,241)
Decrease (increase) in other accounts receivable	(1,129)	12,478	3,914
Increase (decrease) in trade payables	5,666	1,604	(2,602)
Increase (decrease) in other accounts payable	925	(12,875)	6,674
Increase in customer advances	5,351	1,345	575
Net cash provided by operating activities	53,372	55,640	47,384

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	2010	Year ended December 31, 2009	2008
Cash flows from investing activities:			
Acquisition of newly-consolidated subsidiaries and activities (Appendix C)	(13,975)	(1,262)	(13,633)
Proceeds from realization of investment in previously-consolidated subsidiaries (Appendix D)	-	3,482	-
Proceeds from sale of activity in a consolidated company	146	105	-
Proceeds from sale of affiliates company	-	-	150
Proceeds from sale of subsidiary's operation	-	-	15,506
Changes in restrictions on short term deposit	-	4,040	(4,040)
Restricted short term deposit, net	400	-	-
Purchase of property and equipment	(5,348)	(2,713)	(4,055)
Proceeds from (investment in) marketable securities, net	12,246	3,064	(6,795)
Proceeds from sale of property, plants and equipment	446	5,666	1,011
Investment in and loans to affiliates and other companies	(1,160)	-	(187)
Other investments	(282)	-	(756)
Payments to former shareholders of consolidated company	(121)	(6,455)	(5,973)
Changes in short term deposits, net	13,445	(11,945)	(1,659)
Proceeds from long term bank deposits	-	139	3,090
Capitalization of software development and other costs	(9,186)	(6,960)	(6,683)
Purchase of non-controlling interests in subsidiaries	-	-	(16,983)
Net cash used in investing activities	(3,389)	(12,839)	(41,007)

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	2010	Year ended December 31, 2009	2008
Cash flows from financing activities:			
Exercise of employees stock options in subsidiaries	1,850	1,224	876
Dividend paid to non-controlling interests in subsidiaries	(13,959)	(8,400)	(5,612)
Dividend to Formula's shareholders	(19,986)	(29,964)	(10,162)
Short-term bank credit, net	(229)	(247)	(15,151)
Repayment of long-term loans from banks and others	(7,574)	(8,616)	(10,855)
Receipt (payment) of short-term loans	(3,381)	1,580	(750)
Share issuance in a subsidiary to non-controlling interest, net	20,290	-	-
Purchase of non-controlling interests	(3,768)	(3,774)	-
Proceeds from SWAP transactions	-	1,061	-
Repayment and repurchase of debenture	(15,927)	(5,824)	(18,128)
Net cash used in financing activities	(42,684)	(52,960)	(59,782)
Effect of exchange rate changes on cash and cash equivalents	3,004	(238)	2,481
Net increase (decrease) in cash and cash equivalents	10,303	(10,397)	(50,924)
cash and cash equivalents at beginning of year(*)	100,205	110,602	161,526
Cash and cash equivalents at end of year (*)	110,508	100,205	110,602

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

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	2010	Year ended December 31, 2009	2008
a. Supplemental cash flow information::			
Cash paid in respect of:			
Interest	3,847	4,064	5,077
Income tax	7,356	4,444	5,192
b. Non-cash activities:			
Dividend payable to Formula's shareholders and to non-controlling interests in subsidiaries	-	6,694	29,964
Assets retirement obligation	-	275	-
Receivables from sale of property	-	450	-
c. Acquisition of newly-consolidated subsidiaries and activities:			
Assets and liabilities of subsidiaries consolidated as of acquisition date:			
Working capital (other than cash and cash equivalents)	(3,341)	-	(6,209)
Property and equipment	(304)	-	(543)
Goodwill and intangible assets	(18,040)	(1,262)	(15,845)
Long-term liabilities	5,199	-	395
Other long term assets	717	-	-
Long term deferred tax liability	(173)	-	1,771
Liability to formerly shareholders	-	-	6,723
Non-controlling interests at acquisition date	1,967	-	75
Total	(13,975)	(1,262)	(13,633)
d. Proceeds from realization of investments in previously-consolidated subsidiaries:			
Working capital (other than cash and cash equivalents)	-	(2,259)	-
Property and equipment	-	144	-
Other assets, deferred expenses and long term payables	-	1,337	-
Goodwill	-	206	-
Adjustment to other comprehensive (loss) gain	-	(230)	-
Gain from realization of investments in subsidiaries	-	4,284	-
Total	-	3,482	-

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

F-13

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

a. 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 ("TASE") and since 1997, through American Depositary Shares ("ADS") under the symbol FORTY on the Global Market in the United States ("NASDAQ"). 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 through its three subsidiaries in two reportable segments: IT Services and Proprietary Software Solutions. For a description of the Company's operations see Note 16G.

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

Name of subsidiary	Percentage of ownership and control	
	December 31,	
	2010	2009
Matrix IT Ltd. ("Matrix")	50.1	50.1
Magic Software Enterprises Ltd. ("Magic")	51.7	58.1
Sapiens International Corporation N.V. ("Sapiens")	71.6	70.4

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

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES

a. The consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ("U.S. GAAP").

b. Use of estimates:

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and accompanying notes. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

c. Financial statements in U.S. dollars:

The functional currencies of Formula's subsidiaries are NIS and U.S. dollars. Formula has elected to use U.S. dollar as its reporting currency for all years presented.

Formula translates the financial statements of its subsidiary whose functional currency is NIS, into U.S. dollars, under the principles described in ASC 830. 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 in equity under "accumulated other comprehensive income (loss)".

d. Principles of consolidation:

The consolidated financial statements include Formula's financial statements as well as those of its subsidiaries in which it has controlling interests. All intercompany balances and transactions have been eliminated upon consolidation.

Non-controlling interests of subsidiaries represent the non-controlling shareholders' share of the total comprehensive income (loss) of the subsidiaries and fair value of the net assets upon the acquisition of the subsidiaries. The non-controlling interests are presented in equity separately from the equity attributable to the equity holders of the Company.

e. Cash equivalents:

Cash equivalents are considered by the Company to be highly-liquid investments, including, inter-alia, short-term deposits with banks, which the maturity dates are less than three months at the time of acquisition and which are unrestricted.

f. Short-term deposits:

Short-term deposits are deposits with maturities of more than three months but less than one year. Short-term deposits are presented at their costs including accrued interest.

g. Marketable securities:

The Company accounts for investments in marketable securities in accordance with ASC 320, "Investments - Debt and Equity Securities". Management determines the appropriate classification of its investments in marketable debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt and equity securities are classified as available-for-sale or as trading and reported at fair value.

F-15

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Unrealized gains and losses from marketable securities classified as "available for sale" are excluded from earnings and are reported as a component in equity under "accumulated other comprehensive income (loss)". Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in financial income, net, together with accretion (amortization) of discount (premium), and interest or dividends.

Unrealized gains and losses from marketable securities classified as "trading" are reported in the statements of operations. 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 statements of operations.

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

For declines in value of debt securities, effective January 1, 2009, the Company applies an amendment to ASC 320. Under the amended impairment model, other-than-temporary impairment loss is deemed to exist and recognized in earnings if the Company intends to sell or if it is more likely than not that it will be required to sell, a debt security, before recovery of its amortized cost basis. If the criteria mentioned above do not exist, the Company evaluates the collectability of the security in order to determine if the security is other than temporary impaired.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

h. Inventories:

Inventories are mainly comprised of hardware. Inventories are valued at the lower of cost or market value. Cost is determined on the "first in - first out" basis.

i. 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.

j. Property, plant 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:

	%
Computers and equipment	7-33 (mainly 33%)
Motor vehicles	15
Buildings	2-4
Leasehold improvements	*-))

*) Over the shorter of the term of the lease or the estimated useful life of the asset.

k. Intangible assets:

Intangible assets are comprised of software development costs and from other intangible assets:

1. Software development costs:

Development costs of software which is intended for sale, that are incurred after the establishment of technological feasibility of the relevant product, are capitalized.

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

The Company's and its subsidiaries' technological feasibility is established upon completion of a detailed program design or working model.

F-17

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Capitalized software costs are amortized on a product by product basis. Amortization equals the greater of the amount computed using the: (i) ratio of current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (generally three to six years).

During the year ended December 31, 2010, consolidated subsidiaries capitalized software development costs aggregated to \$ 9,100 (2009 - \$ 6,800) and amortized capitalized software development costs aggregated to \$ 9,100 (2009 - \$ 8,400, 2008 - \$ 7,000).

2. Other intangible assets:

Other intangible assets are comprised of customers 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. Amortization is computed using the straight-line method as follows:

	%
Prepaid royalties	15 years
Distribution rights	5 years
Technology, usage rights and other intangible assets	3-8 years

The Company re-evaluates every year the remaining useful life of the intangible assets. During 2010, 2009 and 2008, no impairment was required.

1. Impairment of long-lived assets and intangible assets subject to amortization:

The Company's long-lived assets are reviewed for impairment in accordance with ASC 360, "Property, Plant and Equipment" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. During the years ended December 31, 2008, 2009 and 2010, no impairment were identified.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

m. Goodwill:

The Company applies ASC 350, "Intangible - Goodwill and Other". The Company performs its goodwill annual impairment test to its reporting units at December 31 of each year, or more often if indicators of impairment are present.

As required by ASC 350, the impairment test is accomplished using a two- step approach. The first step of the goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. The Company compares the fair value of each reporting unit to its carrying value ('step 1') and if the fair value exceeds the carrying value of the reporting unit net assets, goodwill is considered not impaired, and no further testing is required. If the carrying value exceeds the fair value of the reporting unit, then the implied fair value of goodwill is determined by subtracting the fair value of all the identifiable net assets from the fair value of the reporting unit. An impairment loss is recorded for the excess, if any; of the carrying value of goodwill over its implied fair value ('step 2').

At December 31, 2009, the market capitalization of one reporting unit was below its carrying value. The Company determines the fair value of this reporting unit using the Income Approach, which utilizes a discounted cash flow model, as it believes that this approach best approximates its fair value at this time. Assumptions related to revenue, gross profit, operating expenses, future short-term and long-term growth rates, weighted average cost of capital, interest, capital expenditures, cash flows, and market conditions are inherent in developing the discounted cash flow model. Additionally, the Company evaluated the reasonableness of the estimated fair value of its reporting unit by reconciling to its market capitalization.

The ability to reconcile the gap between the market capitalization and the fair value depends on various factors, some of which are quantitative, such as an estimated control premium that an investor would be willing to pay for a controlling interests in the Company, and some of which are qualitative and involve management judgment, including stable relatively high backlog and growing pipe line.

During the years ended December 31, 2010, 2009 and 2008, no impairment was required.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

n. Business combinations:

Effective January 1, 2009, the Company adopted the amended ASC 805, "Business Combinations". ASC 805 requires recognition of assets acquired, liabilities assumed, and non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. This ASC also requires the fair value of acquired in-process research and development ("IPR&D") to be recorded as intangibles with indefinite lives, contingent consideration to be recorded on the acquisition date, and restructuring and acquisition-related deal costs to be expensed as incurred. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in earnings. In addition, changes in valuation allowance related to acquired deferred tax assets and in acquired income tax position are to be recognized in earnings.

ASC 805 is applied prospectively for all business combinations occurring after January 1, 2009, except for changes in valuation allowance related to deferred tax assets and changes in acquired income tax position originating from business combinations that occurred prior to the effective date of this ASC, which are recognized in earnings following the adoption date.

o. Variable interest entities:

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

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

Effective January 1, 2010, the Company adopted an updated guidance for the consolidation of variable interest entities. This new guidance replaces the prior quantitative approach for identifying which enterprise should consolidate a variable interest entity, which was based on which enterprise was exposed to a majority of the risks and rewards, with a qualitative approach, based on which enterprise has both (1) the power to direct the economically significant activities of the entity and (2) the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the variable interest entity. Determination about whether an enterprise should consolidate a variable interest entity is required to be evaluated continuously as changes to existing relationships or future transactions. The adoption of this standard did not have a material impact on our financial position or results of operations.

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

p. Severance pay:

The Company's and its subsidiaries' obligation for severance pay with respect to their Israeli employees is calculated pursuant to the Israeli Severance Pay Law and employee agreements based on the most recent salary of the employees multiplied by the number of years of employment and are presented on an undiscounted basis. The severance pay liability to its employees pursuant to Israeli law and employment agreements is covered in part by managers' insurance policies, for which the Company and its Israeli subsidiaries makes monthly payments. These funds are recorded as assets in the Company's balance sheet. The Company can only make withdrawals from these funds for payments of severance pay.

The Company's and its Israeli subsidiary's agreements with certain of their Israeli employees are in accordance with Section 14 of the Severance Pay Law -1963. 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.

Total expenses (gain) in respect of severance pay for the years 2010, 2009 and 2008 were \$ 1,300, (\$ 1,100) and \$ 7,400, respectively.

q. Revenue Recognition:

The Company, through its subsidiaries, generate revenues primarily from the sale of IT services which includes: software products including maintenance, integration and infrastructure, training and deployment. In addition, the Company also generate revenues from the sale of software licenses and related maintenance and technical support as well as from related IT professional services.

Revenues from IT services are generally recognized in accordance with ASC 605, "Revenue Recognition" and Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" when IT service is provided, and after persuasive evidence of an arrangement exists, no significant Company obligations remain, collection of the resulting receivable is reasonably assured, and the fees are fixed or determinable.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues derived from software license agreements are recognized in accordance ASC 985-605 "Software – revenue recognition", 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.

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

Revenues from consulting and training services provided on hourly basis, are recognized as the services are rendered. Revenues from maintenance and support are recognized over the service period.

Certain of the software license sales may also include implementation and customization services with respect to such software license sales. In addition, the Company also provides consulting services that are not deemed essential to the functionality of the license, as well as outsourcing IT services.

Revenues from license fees (included in the proprietary software products segment) that involve implementation and customization of the Company's software to customer specific requirements are generated by fixed-price or time-and-materials contracts. Revenues generated by fixed-price contracts are recognized in accordance with ASC 605-35 "Revenue Recognition - Construction-Type and Production-Type Contracts" using the percentage-of-completion method.

Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology, and are reviewed and updated regularly by management. After delivery, if uncertainty exists about customer acceptance of the software, license revenue is not recognized until acceptance. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2010, no estimated losses were identified.

Revenues from time-and-materials contracts for which the Company is reimbursed for labor hours at fixed hourly billing rates are recognized as revenues as the services are provided.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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.

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.

r. Provision for warranty:

In light of past experience, the Company does not record any provision for warranties in respect of their products and services.

s. Advertising costs:

The Company records advertising expenses as incurred. Advertising costs were recorded at the amount of \$ 2,400, \$ 2,400, and \$ 5,500 in the years 2010, 2009, 2008 respectively.

t. Income taxes:

The Company and its subsidiaries account for income taxes in accordance with ASC 740, "Income Taxes". This Statement prescribes the use of the asset and 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. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

ASC 740 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under ASC 740, a company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement.

The Group recognizes accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. The total amount of gross unrecognized tax benefits (taxes on income) for the years ended December 31, 2010, 2009 and 2008 was \$ 2,106, \$ 679 and \$ 756, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

u. Earnings per share:

Earnings per share ("EPS") are calculated in accordance with the provisions of ASC 260 "Earning per Share". ASC 260 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:

The Company repurchases its shares from time to time and hold them as a treasury shares. These shares are presented as a reduction of equity, at their cost. Gains and losses upon the sale of these shares, net of related income taxes, are recorded to additional paid-in capital.

w. Concentration of credit risks:

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents, short-term bank deposits, trade receivables and marketable securities. The majority of the Company's cash and cash equivalents, bank deposits and marketable securities are invested with major banks in Israel, the United States and Europe. Management believes that these financial instruments are held in financial institutions with high credit standing, and accordingly, minimal credit risk exists with respect to these investments.

The Group's trade receivables are derived from sales to large organizations located mainly in Israel, North America and Europe. 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.

The Company maintains an allowance for doubtful accounts receivable based upon management's experience and estimate of collectability of each outstanding invoice. The allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection. The doubtful accounts expense for the years ended December 31, 2010, 2009 and 2008 was \$ 487, \$ 468 and \$ 1,068, respectively. To date, the Company has not experienced any material losses on its accounts receivable. The risk of collection associated with accounts receivable is mitigated by the diversity and number of customers.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ASC 860, "Transfers and Servicing", 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. There are no outstanding sales of receivables as of December 31, 2010, 2009 and 2008.

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 (iv) 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.

x. Share-based compensation:

The Company accounts for share-based compensation in accordance with ASC 718, "Compensation - Stock Compensation". ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of income. The Company recognizes compensation expenses for the value of its awards, which have graded vesting based on the accelerated method over the requisite service period of each of the awards, net of estimated forfeitures.

Until 2009, certain of the Company's subsidiaries used the Black-Scholes option-pricing model to measure the fair values of the awards at the date of grant, which requires a number of assumptions, of which the most significant are, expected stock price volatility, and the expected option term. Commencing 2010, all subsidiaries used the Binomial option-pricing model ("the Binomial model") to measure the fair values of the awards at the date of grant. Expected volatility was calculated based upon actual historical stock price movements over the most recent periods ending on the grant date, equal to the expected option term. The expected option term represents the period that the Company's stock options are expected to be outstanding and was determined based on historical experience of similar options, giving consideration to the contractual terms of the stock options.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Magic (the Binomial model):

	2010	2009	2008
Dividend yield	0%	0%	0%
Expected volatility	61.2% - 62.8%	63%	56% - 65%
Risk-free interest rate	2.53%-3.71%	2.73%-3.7%	1.83%
Expected forfeiture (employees)	9.7%	9.8%	11%
Expected forfeiture (executives)	7.1%	7.5%	8%
Contractual term of up to	10 years	10 years	10 years
Suboptimal exercise multiple (employees)	2.3	2.35	2.48
Suboptimal exercise multiple (executives)	3	3	3

Sapiens (Black-Scholes model for grants during 2008-2009):

	Year ended December 31,	
	2008	2009
Expected term	4.25 years	4.25 years
Dividend yield	0%	0%
Expected volatility	78%	90%- 93%
Risk-free interest rate	3%	1.8% - 2.5%

For grants of Sapiens' employees commencing January 1, 2010 (using the Binomial model):

	Year ended December 31, 2010
Contractual life of	6 years
Expected exercise factor	2.5
Dividend yield	0%
Expected volatility	65%-66%
Risk-free interest rate	2.3%-2.8%

There were no grants in Matrix during 2009 and 2010. During 2008, the Company granted 200,000 options using the following assumptions in the Black-Scholes model.

Year ended December 31, 2008

Expected life of	3 - 3.5 years
Dividend yield	50%
Expected volatility	24% - 31%
Risk-free interest rate	4.3%-5.3%

For grants of Formula's employees – see Note 12

F-26

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

y. Derivatives and Hedging:

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

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

Magic entered into forward contracts, these contracts serve to protect net income against the impact of the translation into U.S. dollars of certain foreign exchange-denominated transactions.

Matrix' and Sapiens' transactions did not qualify as hedging instruments under ASC 815. Gains or losses related to the transactions are recognized in current earnings during the period.

The notional amounts of outstanding foreign exchange forward contracts at December 31, 2010 are summarized below:

	Forward contracts	
	Buy	Sell
Euro	\$ 1,003	\$ 1,015
Japanese Yen	1,066	1,106
New Israeli Shekel	845	834
	\$ 2,914	\$ 2,955

At December 31, 2010, the effective portion of the Company's cash flow hedges before tax effect was \$ 11, all of which is expected to be reclassified from accumulated other comprehensive income to revenues within the next 12 months.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

z. Comprehensive income (loss):

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

aa. Fair value measurement:

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

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

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

Level 3 Unobservable inputs which are supported by little or no market activity (for example cash flow modeling - inputs based on assumptions).

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ab. Discontinued operations:

Under ASC 205 "Presentation of Financial statements – Discontinued Operation", when a component of an entity, as defined in ASC 205, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on the disposed component, 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; that is, provided that 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. Reclassifications:

Certain comparative figures have been reclassified to conform to the current year presentation.

ad. Recently issued accounting pronouncements:

1. Adoption of New Accounting Standards during the period:

ASU 2010-06 - In January 2010, the FASB updated the "Fair Value Measurements Disclosures" codified in ASC 820. More specifically, this update require (a) an entity to disclose separately the amounts of significant transfers in and out of Levels 1 and 2 fair value measurements and to describe the reasons for the transfers; and (b) information about purchases, sales, issuances and settlements to be presented separately (i.e. present the activity on a gross basis rather than net) in the reconciliation for fair value measurements using significant unobservable inputs (Level 3 inputs). This update clarifies existing disclosure requirements for the level of disaggregation used for classes of assets and liabilities measured at fair value, and requires disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements using Level 2 and Level 3 inputs. As applicable to the Company, this update became effective as of the first quarter ended December 31, 2010, except for the gross presentation of the Level 3 roll forward information, which is required for annual reporting of December 31, 2010. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

2. Recently issued accounting Standards:

ASU 2009-13 - In October 2009, the FASB issued amendments to the accounting and disclosure for revenue recognition of multiple deliverable revenue arrangements codified in ASC 605-25. These amendments, modify the criteria for recognizing revenue in multiple element arrangements and require companies to develop a best estimate of the selling price to separate deliverables and allocate arrangement consideration using the relative selling price method. Additionally, the amendments eliminate the residual method for allocating arrangement considerations. These amendments establish a selling price hierarchy for determining the selling price of a deliverable, which is based on: a) vendor-specific objective evidence; b) third-party evidence; or c) estimates. In addition, this guidance significantly expands required disclosures related to a vendor's multiple-deliverable revenue arrangements.

ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company has adopted the provisions of this guidance as of January 1, 2011. The Company does not believe that the adoption of the new guidance will have a material impact on its consolidated financial statements.

ASU 2010-28 - In December 2010, the EITF issued ASU 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts codified in ASC 350, "Intangibles - Goodwill and Other". Under ASC 350, testing for goodwill impairment is a two-step test, in which Step 1 compares the fair value of the reporting unit to its carrying amount. If the fair value of the reporting unit is less than its carrying value, Step 2 is completed to measure the amount of impairment, if any. This ASU modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 if it appears more likely than not that a goodwill impairment exists.

In determining whether it is more likely than not that a goodwill impairment exists, an entity would consider whether there are any adverse qualitative factors indicating that an impairment may exist (e.g., a significant adverse change in the business climate). The Company does not believe that the adoption of the new guidance will have a material impact on its consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ASU 2010-29 - In December 2010, the EITF issued ASU 2010-29, "Disclosure of Supplementary Pro Forma Information for Business Combinations" codified in ASC 805, "Business Combinations". This ASU responds to diversity in practice about the interpretation of the pro forma disclosure requirements for business combinations. When a public entity's business combinations are material on an individual or aggregate basis, the notes to its financial statements must provide pro forma revenue and earnings of the combined entity as if the acquisition date(s) had occurred as of the beginning of the annual reporting period. The ASU clarifies that if comparative financial statements are presented, the pro forma disclosures for both periods presented (the year in which the acquisition occurred and the prior year) should be reported as if the acquisition had occurred as of the beginning of the comparable prior annual reporting period only and not as if it had occurred at the beginning of the current annual reporting period.

The ASU also expands the supplemental pro forma disclosure requirements to include a description of the nature and amount of any material non-recurring adjustments that are directly attributable to the business combination. The Company has determined not to early adopt the new guidance. The Company does not believe that the adoption of the new guidance will have a material impact on its consolidated financial statements.

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

- a. In 2008, Matrix purchased all the shares of TACT Computers and Systems Ltd. ("TACT") for an aggregate consideration of \$ 12,500. In 2009, Matrix paid to the sellers an additional and final consideration of approximately \$ 6,400.

The following table summarizes the fair values of assets acquired and liabilities assumed as of the date of purchase:

Current assets	9,615
Property and equipment	299
Goodwill	10,535
Customer related intangible asset	1,884
Total tangible and intangible assets acquired	22,333
Current liabilities	8,465
Other long-term liabilities	1,372
Total liabilities assumed	9,837
Net assets acquired	12,496
Cash paid	12,496

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

- b. In October 2009, the Company completed the sale of 100% of its shares in its subsidiary, NextSource, for aggregate consideration of approximately \$12,000, of which \$ 8,000 was paid in cash and the remainder through the release of \$ 4,000 bank deposits that were previously pledged in favor of banks to secure obligations of NextSource. The gain in the amount of approximately \$ 4,300 was presented in the income statement as income from discontinued operation.
- c. On January 17, 2010, Magic, through its U.S subsidiary Fusion Solution LLC, completed the acquisition of a consulting and staffing services business of a U.S-based IT services company, for a total consideration of \$ 13,683, of which \$ 8,625 was paid upon closing and the remaining \$ 5,058 is to be paid over a three year period, of which, \$ 506 is contingent upon the acquired business meeting revenue goals, and \$ 4,552 in deferred payments. The Company believes that sufficient probability to meet these goals exists. The Company classified both the deferred payment and contingent considerations as a liability as of the date of the transaction.

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

The acquired business provides a comprehensive range of consulting and staffing services for the telecom, network communications and the information technology industry. The cash consideration of \$ 8,625 was financed with the Company's own resources. The Company believes that the acquisition of this business activity will enable it to expand its presence in the U.S. market and leverage its relationships with top tier customers as well as take advantage of the synergies between its existing IT services and the acquired operation.

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

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed, with reference to the acquisition as of January 17, 2010:

Working capital, including deferred tax liability	3,925
Fixed assets	54
Goodwill	4,831
Customer relationships	4,873
Total assets acquired	13,683
Total liabilities assumed	5,058
Net assets acquired	8,625

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

Below are certain unaudited pro forma combined statements of income data for the year ended December 31, 2009, as if the acquisition had occurred January 1, 2009, after giving effect to purchase accounting adjustments, including amortization of identifiable intangible assets, mainly customer relationships. This pro forma financial information is not necessarily indicative of the combined results that would have been attained had the acquisition taken place at the beginning of 2009, nor is it necessarily indicative of future results. Pro forma for 2010 was not provided since the activity was consolidated in the 2010 financial statements of income for 11.5 months, which was considered as fully consolidated for 2010.

	Year ended December 31, 2009 Unaudited
Total revenues	79,137
Net income attributable to Formula's shareholders	7,948
Earnings per share	
Basic	0.25
Diluted	0.25

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

d. In 2010, the Company's subsidiaries, Matrix, Magic and Sapiens, completed the acquisition of additional activities for an aggregate total consideration of \$ 8,000, of which \$ 2,000 is contingent upon the acquired activities meeting certain goals.

e. In 2010, the Company's subsidiaries, Matrix, Magic and Sapiens, completed the acquisition of additional businesses for an aggregate total consideration of \$ 8,080, of which \$ 1,800 is contingent upon the acquired businesses meeting certain goals. As of December 31, 2010, the fair value of the contingent consideration is \$ 952.

NOTE 4:- MARKETABLE SECURITIES

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

a.	Composition:	
	Interest rate December 31, 2010 %	December 31, 2010 2009
Short-term:		
Trading securities (1)		35,313 40,491
Available-for-sale securities		2,857 3,680
Total short-term securities		38,170 44,171
Long-term:		
Auction rate security (2)		2,373 6,980
Available-for-sale security		455 401
Total long-term securities		2,828 7,381

(1) The Company recognized trading gains in the amount of \$ 2,276 and \$ 1,362 during the years ended December 31, 2010 and 2009, respectively.

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 4:- MARKETABLE SECURITIES (Cont.)

(2)The auction rate security's interest rates are reset through a "Dutch" auction each month. The monthly auctions historically have provided a liquid market for these securities. With the liquidity issues experienced in global credit and capital markets, the available for sale securities have experienced multiple failed auctions as the amount of securities submitted for sale has exceeded the amount of purchase orders.

b.The following is a summary of marketable securities which are classified as available-for-sale:

	December 31,							
	2010				2009			
	Amortized cost	Unrealized losses	Unrealized Gains	Market value	Amortized cost	Unrealized losses	Unrealized gains	Market value
Available-for-sale:								
Government bonds	407	-	37	444	407	-	37	444
Commercial bonds	4,614	127	90	4,577	10,245	377	175	10,043
Equity securities	1,816	1,243	91	664	1,971	1,452	55	574
Total available-for-sale marketable securities	6,837	1,370	218	5,685	12,623	1,829	267	11,061

Out of the unrealized losses as of December 31, 2010 and 2009, \$ 1,370 and \$ 1,452 respectively, of losses are outstanding over twelve month period. The fair value of these marketable securities which bear losses over twelve month period is \$ 2,828 and \$ 401, respectively.

During the years ended December 31, 2010 and 2009, the Company recorded an impairment loss for its investment in equity security in the amount of \$ 155 thousands and \$ 143, respectively.

In 2010 and 2009, the Company received proceeds from sales of available for-sale marketable securities of \$ 5,079 thousand and \$ 107 thousand respectively and recorded related net gains (losses) of \$ (77) thousand and \$ 22 thousand in financial income, respectively.

c.The amortized costs of available-for-sale debt securities at December 31, 2010, by contractual maturities, are shown below:

Unrealized gains (losses)

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	Amortized cost	Gains	Losses	Estimated fair value
Due in one year or less	1,525	40	-	1,565
Due between one year to five years	3,496	214	(127)	3,583
	5,021	254	(127)	5,148

F-35

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5: - FAIR VALUE MEASUREMENT

In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and considers counterparty credit risk in its assessment of fair value.

The fair value of the liabilities is approximately the presented value.

The Company's financial assets measured at fair value on a recurring basis, excluding accrued interest components; consisted of the following types of instruments as of December 31, 2010 and 2009:

	Fair value measurements using input type			Total
	Level 1	Level 2	Level 3	
December 31, 2010				
Assets:				
Shares	3,305	-	-	3,305
Government and corporate debentures	32,638	2,018	-	34,656
Equity securities	664	-	-	664
Available-for-sale long- term	-	-	2,373	2,373
Total financials assets	36,607	2,018	2,373	40,998
Liabilities:				
Foreign currency derivative contracts	-	40	-	40
Put option contracts	-	-	434	434
Liability in respect of business combination	-	-	5,481	5,481
Total financials liabilities	-	40	5,915	5,955

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5: -

FAIR VALUE MEASUREMENT (Cont.)

	Fair value measurements using input type			Total
	Level 1	Level 2	Level 3	
December 31, 2009				
Assets:				
Short-term deposits	13,838	-	-	13,838
Shares	868	-	-	868
Government and corporate debentures	40,262	2,868	-	43,130
Derivative	-	2,302	-	2,302
Equity security	173	-	-	173
Corporate debentures-long term *)	401	2,500	4,480	7,381
Total financials assets	55,542	7,670	4,480	67,692
Liabilities:				
Put option contracts	-	-	216	216
Liability in respect of business combination	-	-	2,964	2,964
Total financials liabilities	-	-	3,180	3,180

(*)The available-for-sale securities with unquoted prices fair value was determined by a valuation. The fair value was based on a trinomial discount model employing assumptions that market participants would use in their estimates of fair value.

The assumptions included, among others, the following: the underlying structure of the security, the financial standing of the issuer, stated maturities, estimates of the probability of the issue being called at par prior to final maturity, estimates of the probability of defaults and recoveries, auctions failure and successful auction or repurchase at par for each period, expected changes in interest rates paid on the securities, interest rates paid on similar instruments, and an estimated illiquidity discount due to extended redemption periods. Finally, the present value of the future principal and interest payments was discounted at rates considered to reflect current market conditions for each security (see Note 4).

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5: - FAIR VALUE MEASUREMENT (Cont.)

The following table summarizes the activity for those financial assets where fair value measurements are estimated utilizing Level 3 inputs.

	December 31,	
	2010	2009
Carrying value as of January 1	4,480	5,000
Sale of financial assets *)	(2,107)	-
Net changes in fair value	-	(250)
Impairment:		
Impairment to credit loss	-	(143)
Impairment to non-credit loss	-	(127)
Carrying value as of December 31	2,373	4,480

*) The proceed from the sale of the financial assets in 2010 was \$ 2,268

NOTE 6:-INVESTMENTS IN AFFILIATED COMPANY

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

a. Group's share of the associates' statement of financial position based on the interests therein at reporting date:

	December 31,	
	2010	2009
Current assets	2,360	2,642
Noncurrent assets	1,026	1,243
Current liabilities	981	547
Noncurrent liabilities	11	77
	2,394	3,261
Other investments	815	449
	3,209	3,710

b. Group's share of the associates' statement of operation based on the interests therein during the year:

	Year ended December 31,	
	2010	2009

Revenues	6,592	7,996
Loss	1,070	335

F-38

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 7: - PROPERTY, PLANTS AND EQUIPMENT, NET

Composition:

	December 31,	
	2010	2009
Cost:		
Computers and equipment	48,615	43,735
Motor vehicles	732	572
Buildings	3,552	3,210
Leasehold improvements	8,045	6,057
	60,944	53,574
Accumulated depreciation:		
Computers and equipment	41,382	37,476
Motor vehicles	573	412
Buildings	1,749	1,493
Leasehold improvements	4,829	4,204
	48,533	43,585
Depreciated cost	12,411	9,989

Depreciation expenses totaled \$ 4,000, \$ 4,000 and \$ 4,600 for the years ended December 31, 2010, 2009 and 2008, respectively.

In 2009, Magic sold its office buildings in Hungary and Israel for \$ 535 and \$ 5,200, respectively. As a result of the sales, Magic recorded net gains of approximately \$ 289 and \$ 1,960, respectively.

NOTE 8:- GOODWILL

The changes in the carrying amount of goodwill for the years ended December 31, 2010 and 2009 are as follows:

Balance as of January 1, 2009	144,005
Additions due to past contingent consideration related to past acquisitions *)	2,773
Foreign currency translation adjustments	629
Balance as of December 31, 2009	147,407
Acquisition of newly-consolidated subsidiaries	12,622
Additions due to past contingent consideration related to past acquisitions *)	669
Foreign currency translation adjustments	5,797

Balance as of December 31, 2010

166,495

- *) Acquisitions occurring prior to January 1, 2009 were accounted for using the purchase method of accounting in accordance with prior GAAP (SFAS 141 "Business Combination").

F-39

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9:- INTANGIBLE ASSETS, NET

Composition:

	December 31,	
	2010	2009
a. Original amounts:		
Capitalized software development costs	94,292	82,298
Other intangibles	12,511	11,577
Customer relationship and acquired technology	7,546	1,907
	114,349	95,782
Accumulated amortization:		
Capitalized software development costs	69,303	57,697
Other intangibles	9,396	8,644
Customer relationship and acquired technology	2,549	1,907
	81,248	68,248
Total	33,101	27,534

b. Amortized expenses totaled \$ 11,400, \$ 9,800 and \$ 8,100 for the years ended December 31, 2010, 2009 and 2008, respectively. As for impairment of software development cost, see Note 2k.

c. Estimated intangible assets amortization for the years ended:

December 31,

2011	10,411
2012	8,522
2013	5,749
2014	3,691
2015	2,505
2016 and thereafter	2,223
Total	33,101

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 10:-LIABILITIES TO BANKS AND OTHERS

a.Composition:

December 31, 2010 Interest rate %	Linkage basis	Long-term liabilities	Current maturities December 31, 2010	Total long- term liabilities net of current maturities	Total long- term liabilities net of current maturities December 31, 2009
4-6	NIS– Israeli Prime	9,152	6,148	3,004	8,530
	Other	159	9	150	26
Total		9,311	6,157	3,154	8,556

b.Maturity dates:

	December 31, 2010	December 31, 2009
First year (current maturities)	6,157	6,840
Second year	3,006	5,940
Third year	148	2,616
Total	9,311	15,396

c.For details of liens, guarantees and credit facilities see Note 13.

NOTE 11:-DEBENTURES

a.Comprised as follows:

	Linkage	Interest rate	December 31, 2010	December 31, 2009
Non-convertible Debentures (b)	CPI	5.15 %	47,781	58,557
Less - current maturities of debentures			(15,927)	(14,639)

Total	31,854	43,918
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F-41

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:-DEBENTURES (Cont.)

b.Non-convertible debentures:

The non-convertible debentures were issued by Matrix in August 2007 for an aggregate amount of NIS 250,000 (approximately \$ 62,000).

The debentures bear 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 CPI. On February 21, 2008, Matrix listed the debentures for trading on the TASE. The fair value of the debentures as of December 31, 2010 and 2009 is \$ 51,604 and \$ 63,475, respectively. See Note 13 for information regarding covenants related to the non-convertible debentures.

In 2008, Matrix repurchased debentures value, amounting to \$ 12,600 of the outstanding debentures. As a result, an amount of \$ 500 was recorded as a gain on repurchase of debentures.

NOTE 12:-

EMPLOYEE OPTION PLANS

a.In March 2008, Formula's shareholders approved the adoption of Formula's 2008 Employee and Officer Share Option Plan, referred to as "the plan". Pursuant to the plan, the Company may grant from time to time to the Company's and its subsidiaries' employees and officers (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.

In January 2009, Formula granted to the CEO, in connection with his new service agreement, options to purchase 396,000 Ordinary shares. These options vest over a three-year period, commencing on December 17, 2008, on a quarterly basis. The exercise price of the options is NIS 0.01 per share. The options shall expire six years of the date of grant. These options are amortized in accordance to the Group's option amortization methodology. In April 2010 the CEO exercised all the options to shares. Total fair value of the grant was calculated based on the price share on the grant date and summed to \$ 926 thousands (\$ 2.34 per share).

In March 2011, concurrently with the amendment and extension of the Company's CEO service agreement, the Company approved the grant of options to the CEO, exercisable to an additional 542,000 shares for no consideration. The options, vest in equal quarterly installments over a four year period that commences in December 2011 and concludes in December 2015.

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- EMPLOYEE OPTION PLANS (Cont.)

b. The Company's subsidiaries granted options to their employees to purchase shares in the respective companies. The options were mainly granted during the years 1999-2010. In general, the options expire 7-10 years after grant. For further information with respect to expenses relating to the benefit to the employees, and additional disclosure required by ASC 718, see Note 2w.

c. The following table sets forth the total stock-based compensation expense resulting from stock options included in the consolidated statements of income.

	Year ended December 31,		
	2010	2009	2008
Cost of revenues	2	2	20
Research and development expenses	61	26	13
Selling and marketing expenses	75	32	112
General and administrative expenses	1,326	1,581	1,360
Total stock-based compensation expense	1,464	1,641	1,505

The following table is a summary of the status of option plans in Magic as of December 31, 2010:

	Number of options	Weighted average exercise price \$	Weighted average remaining contractual term Years	Aggregate intrinsic value \$
Options outstanding at the beginning of the year	1,927,199	2.28		
Granted	498,000	1.44		
Exercised	(685,564)	1.95		
Forfeited	(75,447)	5.59		
Outstanding at the end of the year	1,664,188	2.02	6.49	6,928
Vested and expected to vest at the end of the year	1,583,891	2.06	6.36	3,352
Exercisable at the end of the year	933,688	2.59	4.48	6,528

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12: -EMPLOYEE OPTION PLANS (Cont.)

The weighted-average grant-date fair value of options granted during the years ended December 31, 2010, 2009 and 2008 was \$ 1.88, \$ 0.87 and \$ 0.68, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value that would have been received by the option holders had all option holders exercised their options on December 31, 2010. This amount changes based on the fair value of Magic's Ordinary share.

As of December 31, 2010, there were approximately \$ 89 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Company's equity incentive plan. That cost is expected to be recognized over a weighted-average period of approximately four years. The total intrinsic value of options exercised during the years ended December 31, 2010, 2009, and 2008 was \$ 1,895, \$ 26 and \$ 383, respectively.

The following is a summary of the status of option plans in Matrix as of December 31, 2010:

	Number of options	Weighted average exercise price \$	Weighted average remaining contractual term Years	Aggregate intrinsic value \$
Options outstanding at the beginning of the year	2,171,463	3.23		
Granted	-	-		
Exercised	(2,027,798)	3.18		
Forfeited	-	-		
Outstanding at the end of the year	143,665	3.23	0.916	381
Vested and expected to vest at the end of the year	143,665	3.23	0.916	381
Exercisable at the end of the year	143,665	3.23		381

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- EMPLOYEE OPTION PLANS (Cont.)

The weighted-average grant-date fair value of options granted during the year ended December 31, 2008 was \$0.87. The aggregate intrinsic value in the table above represents the total intrinsic value that would have been received by the option holders had all option holders exercised their options on December 31, 2010. This amount changes based on the fair value of Matrix' Ordinary share. As of December 31, 2010, there were approximately \$ 381 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Company's equity incentive plan. That cost is expected to be recognized over a weighted-average period of 1 year. The total intrinsic value of options exercised during the years ended December 31, 2010, 2009, and 2008 was \$ 3,110, \$ 3,280 and \$ 27, respectively.

The following is a summary of the status of options plans in Sapiens as of December 31, 2010:

	Number of options	Weighted average exercise price \$	Weighted average remaining contractual term Years	Aggregate intrinsic value \$
Options outstanding at the beginning of the year	2,306,963	2.16	5.23	
Granted	789,000	1.92	5.2	
Exercised	(17,282)	1.39	-	
Forfeited	(132,909)	12.24	0.38	
Options outstanding at the end of the year	2,945,772	1.65	4.7	2,026
Vested and expected to vest at the end of the year	2,888,634	1.64	4.69	1,956
Exercisable at the end of the year	1,803,004	1.58	4.56	1,394

The weighted-average grant-date fair value of options granted during the years ended December 31, 2010, 2009 and 2008 was \$ 1.08, \$ 0.59 and \$ 0.64, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value that would have been received by the option holders had all option holders exercised their options on December 31, 2010. This amount changes based on the fair value of sapiens' Ordinary share. As of December 31, 2010, there were approximately \$ 826 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Company's equity incentive plan. That cost is expected to be recognized over a weighted-average period of up to four years. The total intrinsic value of options exercised during

the years ended December 31, 2010, 2009, and 2008 was \$ 16, \$ 0 and \$ 97, respectively.

F-45

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 13:-

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 and 0.35% of the net consolidated consulting services revenue related to the software developed within the framework of these programs. 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 contingent liability in respect of the aforesaid grants amounted to approximately \$ 6,200 as of December 31, 2010.

b.Liens:

Some of the subsidiaries have liens on leased vehicles, leased equipment and other assets in favor of the leasing companies.

c.Guarantees:

- 1.Subsidiaries have provided bank guarantees aggregating to approximately \$ 15,300 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 aggregating to \$ 3,200 as security for rent to be paid for their offices. If the subsidiaries were to breach certain terms of their lease, the lessee could demand that the banks providing the guarantees pay amounts claimed to be due.

Covenants:

-In connection with Matrix' credit facilities agreements with various financial institutions and in connection with non-convertible debentures, Matrix committed to the following:

1. To maintain certain financial ratios. Matrix meet the financial ratios as of December 31, 2010 and 2009..
2. Not to grant a security interest in all or substantially all of their respective assets.
- 3.Matrix committed to not to distribute dividends that will cause its equity to be less than NIS 275,000 (approximately \$ 80,000). As of December 31, 2010, the Matrix' equity is approximately NIS 551,000 (\$ 160,000).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 13:- COMMITMENTS AND CONTINGENCIES (Cont.)

e. Legal proceedings:

1. In 2010, a former customer of Sapiens filed a claim in the arbitration court in Warsaw, Poland against Sapiens, claiming an amount of approximately €3,400 ((approximately \$ 4,750) for damages caused by Sapiens in the project for such former customer more than two years ago. Sapiens does not accept the claim and based on the consultations with its legal counsel, believes that it has a reasonable defense.

2. In February 2010, a U.S. company filed a lawsuit against Magic and one of its subsidiaries claiming an alleged breach by Magic and the subsidiary of its intellectual property rights in connection with one of Magic's products. No monetary damage was claimed.

Due to the preliminary stage of the litigation, and based on the advice of its legal advisors, Magic cannot predict the outcome of the lawsuit nor can it make any estimate of the amount of damages; therefore, no provision has been made for the lawsuit.

3. In August 2009, a software company filed a lawsuit in arbitration against Magic Software, claiming an alleged breach of a non-disclosure agreement between the parties. The plaintiffs are seeking damages in the amount of approximately \$13.7 million. Closing summaries have not yet been submitted in the proceedings with respect to the amount of damages, and therefore, at this time Magic Software is not able to estimate the amount of damages and no provision has been made for the arbitration.

4. In addition, other lawsuits have been filed against the Company's subsidiaries in the ordinary course of business. The Company applied ASC 450, "Contingencies", and recorded a 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, 2010:

2011	21,189
2012	19,301
2013	13,190
2014	5,423
2015 and thereafter	2,343
	61,446

Rent expenses for the years 2010, 2009 and 2008, were approximately \$ 15,000 \$ 14,000 and \$ 15,600, respectively.

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- EQUITY

The composition of share capital is as follows:

	December 31, 2010			December 31, 2009		
	Authorized	Issued	Outstanding	Authorized	Issued	Outstanding
Ordinary shares, NIS 1 par value each	25,000,000	13,620,780	13,596,000	25,000,000	13,224,780	13,200,000

1. Formula's shares are traded on the TASE and its ADS, each representing one Ordinary share of NIS 1 par value, on the NASDAQ.

2. Formula holds 24,780 of its Ordinary shares.

3. In 2008, the Company paid a dividend of approximately \$ 10,000 and declared a dividend of approximately \$ 30,000 which paid in January 2009.

4. In April 2010, the Company declared on dividend of approximately \$20,000 and paid approximately \$ 10,000 of it.

5. For Employee and Officer Share Option Plan, see Note 12.

6. In December 2010, Magic consummated a private placement of ordinary shares and warrants with several institutional and private investors for aggregate gross proceeds of \$23,000 (excluding finders' fees and transaction expenses). If the warrants are exercised in full, Magic will receive additional proceeds of approximately \$9,400.

NOTE 15:-INCOME TAXES

a. Tax laws in Israel:

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

Some operations of certain subsidiaries have been granted the status of an "Approved Enterprise" which was granted under the Law before April 1, 2005. According to the provisions of the Law, the subsidiaries have elected the "alternative benefits" program and as such are entitled to tax exemption of two to four years and to a reduced tax rate of 10%-25% depending on the level of foreign investment in the technologies. 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 subsidiaries may be required to refund the amount of the benefits, in whole or in part, including interest.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

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 the Company, would be taxed at the corporate tax rate applicable to such income as if the Company had not elected the alternative tax benefits (currently 25% of the gross dividend).

The Company 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". Income from sources other than the "Approved Enterprise" during the period of benefits will be taxable at general corporate tax rates.

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Law. The Amendment enacted major changes in the manner in which tax benefits are awarded under the Law so that companies are no longer required to get the Investment Center's prior approval to qualify for tax benefits. Such an enterprise is a "Privileged Enterprise", rather than the previous terminology of Approved Enterprise. The period of tax benefits for a new Privileged Enterprise commences in the "Year of Commencement", which is the later of: (1) the year of election, or (2) the year in which taxable income is first generated by the company after the election year.

The Amendment limits the scope of enterprises, which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise such as the provision generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export.

In December 2010, the "Knesset" (Israeli Parliament) passed the Law for Economic Policy for 2011 and 2012 (Amended Legislation), 2011, which prescribes, among others, amendments in the Law for the Encouragement of Capital Investments, 1959 ("the Law"). The amendment became effective as of January 1, 2011. According to the amendment, the benefit tracks in the Law were modified and a flat tax rate applies to the Company's entire preferred income. The Company will be able to opt to apply (the waiver is non-recourse) the amendment and from then on it will be subject to the amended tax rates that are: 2011 and 2012 - 15% (in development area A - 10%), 2013 and 2014 - 12.5% (in development area A - 7%) and in 2015 and thereafter - 12% (in development area A - 6%).

2. 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 accelerated depreciation as stipulated by regulations published under the Inflationary Adjustments Law and tax deduction over a period of 3 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

3.Tax rates applicable to income in Israel:

Until 2008, results for Israeli tax purposes were measured on a real basis as adjusted for the increase in CPI. In 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 have been measured in nominal values, excluding certain adjustments for changes in the CPI carried out in the period up to December 31, 2007. The amended law includes, inter alia, the elimination of the inflationary additions and deductions.

The general corporate tax rate in Israel in 2010 was 25%. The corporate tax rate is to be reduced in 2011 to 24%. On July 23, 2009, the Israel Economic Efficiency Law (Legislation Amendments for Applying the Economic Plan for 2009 and 2010), 2009 (hereinafter – the 2009 Amendment), became effective, stipulating, among other things, an additional gradual decrease in tax rates in 2011 and thereafter, as follows: 2011-24%, 2012-23%, 2013-22%, 2014-21%, 2015-20% and 2016 and thereafter-18%.

b.Subsidiaries outside Israel:

Subsidiaries that are not Israeli residents are taxed in their countries of residence, according to the tax laws in those countries.

c.Cumulative tax losses:

The Company and its subsidiaries have cumulative losses for tax purposes as of December 31, 2010 totaling approximately \$ 185,500, of which \$ 177,400 is in respect of companies in Israel (December 31, 2009 - \$ 196,200) which can be carried forward and offset against taxable income in the future for an indefinite period, and approximately \$ 8,200 in respect of companies abroad (December 31, 2009 - \$ 19,700). In assessing the realization of deferred tax assets, management considers whether it is more likely than not that all or some portion of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets is dependent upon the generation of future taxable income during the periods in which temporary differences are deductible and net operating losses are utilized. Based on consideration of these factors, the Company recorded a valuation allowance as detailed in Note 15e below.

The Company recorded a valuation allowance with respect to the attributable to these losses carried forward.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

d. Income tax assessments:

The Company and its subsidiaries are routinely examined by various taxing authorities. Below is a summary of the income tax assessments of the Company and its subsidiaries:

Formula

The Company's tax years 2007 through 2010 remain subject to examination by the Israeli Tax Authorities.

Matrix

Several subsidiaries of the Matrix group entities have final tax assessments through the year 2006. The Israeli Tax Authorities are currently examining income tax returns of Matrix I.T Ltd. and additional subsidiaries at the Matrix Group for the tax years 2005 through 2007.

Magic

Magic (the Israeli entity) has received final tax assessments through the year 2005. Non-Israeli subsidiaries of Magic are taxed according to the tax laws in their respective domiciles of residence. If earnings are distributed to Israel in the form of dividends or otherwise, the Company may be subject to additional Israeli income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes. The Company's management has determined that it will not distribute any amounts of its undistributed tax income as a dividend. The Company intends to reinvest the amount of such tax income. Accordingly, no deferred income taxes have been provided.

Sapiens

Sapiens Technologies and some of its subsidiaries have final tax assessments through the year 2005. Non-Israeli subsidiaries of Sapiens are taxed according to the tax laws in their respective country of residence. If earnings are distributed to Israel in the form of dividends or otherwise, the Company may be subject to additional Israeli income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes. The Company's management has determined that it will not distribute any amounts of its undistributed tax income as a dividend. The Company intends to reinvest the amount of such tax income. Accordingly, no deferred income taxes have been provided.

F-51

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

e.	Deferred taxes:		
1.	Composition:		
	December 31,		
	2010		2009
Net operating losses carried forward	43,120		38,663
Allowances and reserves	3,219		1,006
Differences in measurement basis (cash basis for tax purposes)	(2,159)		(2,907)
	44,180		36,762
Valuation allowance	(29,173)		(25,735)
Total	15,007		11,027
2.	Presentation in balance sheets:		
	December 31,		
	2010		2009
Other current assets	4,526		3,735
Other non-current assets	13,135		9,499
Long-term liabilities	(2,654)		(2,207)
	15,007		11,027
f.	Income before taxes on income:		
	Year ended		
	December 31,		
	2010	2009	2008
Domestic	31,153	24,762	17,900
Foreign	11,463	12,030	7,728
Total	42,616	36,792	25,628

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

g. Income taxes included in the statements of operations:

	2010	Year ended December 31, 2009	2008
Current taxes:			
Domestic	8,149	7,002	3,896
Foreign	1,750	819	1,264
	9,899	7,821	5,160
Deferred taxes:			
Domestic	(4,004)	1,359	(2,012)
Foreign	649	(875)	131
Deferred taxes, net	(3,355)	484	(1,881)
Taxes on income	6,544	8,305	3,279

F-53

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

h. Theoretical tax:

The following is reconciliation between the theoretical tax expense, assuming that all income was taxed at statutory tax rates, and the actual income tax expense, as recorded in the statement of operations:

	2010	Year ended December 31, 2009	2008
Income before income taxes, as per the statement of operations	42,616	36,792	25,628
Statutory tax rate in Israel	25 %	26 %	27 %
Theoretical tax expense	10,654	9,566	6,920
Reconciliation:			
Non-deductible expenses	238	441	193
Tax-exempt income change in tax rate and reduced tax rates in companies which have Approved Enterprises	631	425	8
Deferred taxes on losses (utilization of losses) and temporary differences for which a valuation allowance was provided, net	(3,438)	627	(3,034)
Prior year losses and temporary differences for which deferred taxes were recorded, net	(3,231)	(2,979)	-
Taxes in respect of prior years	735	118	(907)
Other	955	107	99
Income taxes as per the statement of operations	6,544	8,305	3,279
Effective tax rate - in %	15.4 %	22.6 %	12.8 %

i. Uncertain tax positions:

The Company and its subsidiaries adopted the provisions of ASC 740 on January 1, 2007. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with

ASC 740 and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination.

F-54

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:-INCOME TAXES (Cont.)

A reconciliation of the beginning and ending amount of total unrecognized tax benefits in the Company's subsidiaries is as follows:

Balance as of January 1, 2009	756
Reductions related to settlement of tax matters	(229)
Increase related to current year tax positions	142
Addition of interest related to the unrecognized tax liabilities from previous years	10
Balance as of December 31, 2009	679
Increase related to current year tax positions	915
Addition of interest related to the unrecognized tax liabilities from previous years	512
Balance as of December 31, 2010	2,106

NOTE 16:- SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION

Balance Sheets:

a. Other current assets:

Composition:

	2010	December 31, 2009
Government departments	6,424	5,726
Employees (1)	356	355
Prepaid expenses and advances to suppliers	9,495	7,544
Deferred taxes	4,526	3,735
Advanced payments due to M&A activities	1,160	-
Debtors from sale of fixed assets	-	1,306
Derivatives	-	2,292
Other	1,179	1,490
Total	23,140	22,448

(1) Some of these balances are linked to the CPI, and bear interest at an annual rate of 4%.

F-55

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16: -SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (Cont.)

b. Liabilities to Banks:

Composition:

	December 31, 2010	Linkage basis	December 31, 2010	December 31, 2009
	Interest rate %			
Bank credit	4%-6%	Unlinked	527	36
Short-term bank loans	Prime+2%	Unlinked	-	3,179
Current maturities of long-term loans from banks (see Note 10)			6,157	6,840
Total			6,684	10,055

c. Other accounts payable:

Composition:

	December 31, 2010	December 31, 2009
Government institutions	20,260	12,558
Customer advances	280	5,631
Accrued expenses and other current liabilities	10,153	8,805
Total	30,693	26,994

d. Financial expenses, net:

Composition:

	2010	Year ended December 31, 2009	2008
Financial income	1,062	4,160	8,951
Financial costs related to long-term debt	(5,029)	(5,982)	(8,781)
Financial costs related to short-term credit and others	(2,527)	(2,590)	(4,597)
Gain (loss) from marketable securities, net (1) (2)	2,123	4,181	(1,481)

Total	(4,371)	(231)	(5,908)
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(1)Includes gains (losses) from trading securities still held by the Company for the years 2010, 2009 and 2008 in the amounts of \$ 2,276, \$ 1,362 and \$ (1,530) respectively.

(2)Includes impairment of available-for-sale marketable securities for 2010 and 2009 of \$ 153 and \$ 143, respectively due to credit loss (see Note 4).

F-56

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16: -SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (Cont.)

e. Other expenses, net:

Composition:

	2010	Year ended December 31, 2009	2008
Gain on sale of fixed assets, net	-	247	341
Impairment in value of cost-based investment	-	(59)	(502)
Other	(231)	1,480	(419)
Total	(231)	1,668	(580)

f. Operating segments:

The Company operates in the software services and proprietary software solutions segments through its three subsidiaries: Matrix, Sapiens and Magic.

Software Services:

Matrix

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; (iv) offshore and domestic services, mainly for software developments and quality assurance and software testing; and (iv) integration of all or part of these components. Matrix operates in sales and support of software products of leading worldwide vendors. Matrix supplies infrastructure solutions for computer and communication systems and sales hardware products. 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, soft-skills training and training for capital market operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16: - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (Cont.)

Proprietary Software Products

Magic

Magic's technology enables enterprises to accelerate the process of building and deploying business software applications that can be rapidly customized to meet current and future needs.

Magic gives partners and customers the ability to create any type of business applications, leverage existing information technology resources, enhance business ability, and focus on core business priorities to gain maximum return on their existing and new IT investments.

Magic Software is known for its code-free approach, allowing users to focus on business logic rather than technological requirements. This approach forms the driving principle of both the uniPaaS application platform (the next generation of eDeveloper) and the iBOLT business and process integration suite. Both uniPaaS and iBOLT enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems.

During 2010, following the acquisition of consulting and staffing services business Magic also provides software services.

Sapiens

Sapiens is a provider of software solutions for the insurance industry. Sapiens' suite of insurance solutions, built to meet the core business needs of large and small insurance carriers, aligns IT with business demands for speed, flexibility and efficiency. Sapiens' solutions are supplemented by its methodology and consulting services, which address the complex issues related to the life-cycle of enterprise business applications. Sapiens offers its solutions to two of the major lines of insurance business – Life & Pension (L&P) and Property & Casualty (P&C).

Sapiens' insurance solutions are deployed at leading insurance carriers globally. Sapiens' service offerings include a standard consulting offering that helps customers make better use of IT in order to achieve their business objectives.

Sapiens eMerge™, is a rules-based model-driven architecture, that is used to develop most of Sapiens' software products. It enables the creation of mission critical core enterprise applications with little or no coding using agile methodologies. Sapiens' technology allows customers to achieve legacy modernization and enterprise application integration

FORMULA SYSTEMS (1985) LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16: -SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (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 Matrix	Proprietary Software Sapiens	Products Magic	Total
Revenues:				
2010	409,272	52,235	88,578	550,085
2009	368,498	45,698	55,350	469,546
2008	397,925	43,534	61,980	503,439
Inter-segment sales:				
2010	391	-	-	391
2009	153	3	-	156
2008	135	-	61	196
Operating income:				
2010	31,412	6,476	9,099	46,987
2009	26,014	5,087	5,922	37,023
2008	25,502	2,430	3,941	31,873
Financial income (expenses):				
2010	(3,819)	(201)	(351)	(4,371)
2009	377	262	(870)	(231)
2008	(4,648)	(2,012)	752	(5,908)
Net income from continuing operations:				
2010	9,189	4,129	5,061	18,379
2009	8,197	2,703	3,298	14,198
2008	9,190	(1)	2,125	11,314
Identifiable assets including goodwill:				
2010	404,175	68,394	118,818	591,387

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2009	370,206	59,196	93,441	522,843
Identifiable liabilities:				
2010	183,342	22,130	22,386	227,858
2009	148,641	20,822	32,332	201,795
Depreciation and amortization:				
2010	4,235	6,647	4,569	15,451
2009	3,568	5,369	4,600	13,807
2008	3,646	5,142	3,629	12,417
Investments in segment assets:				
2010	4,103	662	583	5,348
2009	1,799	326	580	2,705
2008	2,481	769	738	3,988

F-59

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16:-SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (Cont.)

Reconciliation between the data on income from the operating segments and the data in the consolidated financial statements:

	2010	2009	2008
Revenues:			
Revenues as above	550,085	469,546	503,439
Less inter-segment transactions	(391)	(156)	(196)
Revenues as per statements of operations	549,694	469,390	503,243
		2010	2009
Identifiable assets:			
Total assets of operating segments		591,387	522,843
Assets not identifiable to a particular segment		44,477	64,753
Elimination of inter-segment assets and other		(12,097)	(21,184)
Total assets from continuing operations as per consolidated balance sheets		623,767	566,412
Identifiable liabilities:			
Total liabilities of operating segments		227,858	201,795
Liabilities not identifiable to a particular segment		76,456	93,032
Elimination of inter-segment liabilities and other		(14,931)	(24,016)
Total liabilities from continuing operations as per consolidated balance sheets		289,383	270,811

g. Geographical information:

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

	December 31,	
	2010	2009
Israel	125,734	115,466
United States	20,156	5,245
Europe	10,108	10,143
Japan	6,506	5,826
Other	4,228	1,727

Total	166,732	138,407
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F-60

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16: -SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (Cont.)

2. Revenues:

Revenues classified by geographic area:

	2010	Year ended December 31, 2009	2008
Israel	412,922	368,230	393,391
International:			
United States	73,075	38,862	47,098
Other	63,697	62,298	62,754
Total	549,694	469,390	503,243

Classification was based on the location of the customers.

h. Earnings per share:

The following table presents the computation of basic and diluted net earnings per share from continuing operations:

	2010	Year ended December 31, 2009	2008
Amount for basic earnings per share - income available to shareholders	18,379	14,198	11,314
Effect of dilutive securities of subsidiaries	-	-	-
Amount for diluted earnings per share - income available to shareholders	18,379	14,198	11,314
Weighted average shares outstanding			
Denominator for basic net earnings per share	13,382	13,200	13,200
Effect of dilutive securities	141	364	-
Denominator for diluted net earnings per share	13,523	13,564	13,200

Basic net earnings per share from continuing operations	1.37	1.08	0.84
Diluted net earnings per share from continuing operations	1.36	1.04	0.84

F-61

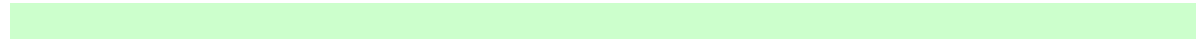
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 17: - DISCONTINUED OPERATIONS

- a. On June 20, 2007, the Company completed the sale of its entire shareholdings in BluePhoenix. BluePhoenix met the definition of a component under ASC 360. Accordingly, the results of operations of BluePhoenix have been classified as discontinued operations in the statement of income 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.
- b. In 2007, Magic disposed of two of its subsidiaries (AAOD and Magic Italy). Both subsidiaries met the definition of a component under ASC 360. 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 income 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. On October 22, 2009, the Company completed the sale of its entire shareholdings in NextSource. The results of operations of NextSource have been classified as discontinued operations in the statement of income 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.
- d. The following is the composition of discontinued operations (including capital gains):

	2010	Year ended December 31, 2009	2008
Revenues	-	64,328	87,564
Cost of revenues	-	57,996	78,488
Gross profit	-	6,332	9,076
Research and development costs, net	-	-	-
Selling, general and administrative expenses	-	5,647	8,156
Operating income	-	685	920
Financial expenses, net	-	(55)	(100)
Capital gains on sale of shareholdings, net	-	4,284	-
Income before income taxes	-	4,914	820
Taxes on income	-	36	265
	-	4,878	555
Equity in losses of affiliates, net	-	-	-



Net income	-	4,878	555
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F-62

FORMULA SYSTEMS (1985) LTD.
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 18: -SUBSEQUENT EVENT

On January 1, 2011, Magic completed the acquisition of its South African distributor, Magic Integration (Pty) Ltd ("Magix"). Based on the acquisition terms Magic will control 51% of Magix with an option to increase its holdings to 75%; for a total consideration of up to \$ 2,500 to be paid in 2011. Magix specializes in the software integration and application development of Magic Software platforms as well as the support of large-scale and complex systems in the public and financial sectors in South Africa. Magic believes that the acquisition of this business activity will enable it to expand its presence in the South African market and leverage its relationships with top tier customers

F-63
