

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

AMENDMENT NO. 1  
TO  
FORM 20-F

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2014

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  
and translation of Registrant's name into English)

**Israel**

(Jurisdiction of Incorporation or Organization)

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

(Address of Principal Executive Offices)

**Asaf Berenstin; 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:

| <u>Title of Each Class</u>   | <u>Name of Each Exchange On Which Registered</u> |
|--|--|
| American Depositary Shares, each<br>representing one Ordinary Share, NIS 1 par value | NASDAQ Global Select 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**

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

**As of December 31, 2014, the registrant had 14,719,782 outstanding ordinary shares, NIS 1 par value, of which 303,879 were represented by American Depositary Shares.**

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

Yes  · No

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

Yes  · No

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

Yes  · No

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

Yes  · No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

U.S. GAAP

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

Other

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

Item 17  Item 18

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

Yes  No



## EXPLANATORY NOTE

This Amendment No. 1 to Form 20-F is being filed to amend the Annual Report on Form 20-F for the fiscal year ended December 31, 2014, filed by Formula Systems (1985) Ltd. (the “Company”) on April 30, 2015 (the “2014 Form 20-F”). This Form 20-F/A is being filed solely to supplement “Item 18: Financial Statements” and “Item 19: Exhibits” of the 2014 Form 20-F with the inclusion of

- the audited financial statements of Magic Software Enterprises Ltd. (“Magic Software”), including the reports of independent public registered accounting firm relating thereto (the “Magic Financial Statements”); and
- the audited financial statements of Sapiens International Company N.V. (“Sapiens”), including the report of independent registered public accounting firm relating thereto (the “Sapiens Financial Statements”).

The Magic Financial Statements and the Sapiens Financial Statements are being filed in compliance with Rule 3-09 of Regulation S-X of the U.S. Securities and Exchange Commission (“Rule 3-09”). Under Rule 3-09, the Company is required to provide audited financial statements for the period of the year ended December 31, 2014 during which each of Magic Software and Sapiens were accounted for under the equity method of accounting (in the case of Magic, from March 5, 2014 to December 31, 2014 and in the case of Sapiens, from January 1, 2014 to December 24, 2014). Pursuant to relief received from the Office of the Chief Accountant of the Division of Corporation Finance of the U.S. Securities and Exchange Commission, rather than file the financial statements for such partial year periods, the Company is including the Magic Financial Statements and the Sapiens Financial Statements which include the full year ended December 31, 2014.

As required by Rule 12b-15 under the Securities Exchange Act of 1934, as amended, updated certifications of the Company’s principal executive officer and the Company’s principal financial officer are being filed as exhibits to the Form 20-F/A. This Form 20-F/A also includes Exhibit 15.5, which contains the consent of Kost, Forer, Gabbay & Kaiserer, a member of Ernst & Young Global, with respect to their report included in the Magic Financial Statements and Exhibit 15.6, which contains the consent of Kost, Forer, Gabbay & Kaiserer, a member of Ernst & Young Global, with respect to their report included in the Sapiens Financial Statements.

This Form 20-F/A should be read in conjunction with the 2014 Form 20-F and the Company’s other filings with the Securities and Exchange Commission. This Amendment No. 1 to the 2014 Form 20-F speaks as of the date of the initial filing of the 2014 Form 20-F. Other than as expressly set forth above, this Form 20-F/A does not, and does not purport to, amend, update or restate the information in any part of the 2014 Form 20-F or reflect any events that have occurred after the 2014 Form 20-F was filed. The filing of this Form 20-F/A, and the inclusion of newly executed certifications, should not be understood to mean that any other statements contained in the 2014 Form 20-F are true and complete as of any date subsequent to April 30, 2015.

## ITEM 18. FINANCIAL STATEMENTS

Our consolidated financial statements and the report of our independent registered public accounting firm in connection therewith were filed as part of our annual report on Form 20-F filed with the Securities and Exchange Commission on April 30, 2015.

The audited financial statements of Magic Software Enterprises Ltd. as of December 31, 2013 and 2014 and the three years ended December 31, 2014 are attached to this Amendment No. 1 to Form 20-F as Exhibit 99.1 and incorporated herein by reference.

The audited financial statements of Sapiens International Corporation N.V. as of December 31, 2013 and 2014 and the three years ended December 31, 2014 are attached to this Amendment No. 1 to Form 20-F as Exhibit 99.2 and incorporated herein by reference.

## ITEM 19. EXHIBITS

| <b>Exhibit<br/>No.</b> |  |
|------------------------|--|
|------------------------|--|

|      |   |
|------|---|
| 1.1  | Memorandum of Association <sup>(1)</sup>  |
| 1.2  | Amended and Restated Articles of Association, as adopted by Formula Systems (1985) Ltd. on January 8, 2012 <sup>(2)</sup>   |
| 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. <sup>(1)</sup>                          |
| 4.1  | Form of Letter of Indemnification for officers and directors, adopted by Formula Systems (1985) Ltd. on January 8, 2012 <sup>(3)</sup>  |
| 4.2  | English translation of Formula Systems (1985) Ltd. Employees and Office Holders Share Option Plan (2008) <sup>(4)</sup>   |
| 4.3  | Formula Systems (1985) Ltd. 2011 Share Incentive Plan and amendment <sup>(5)</sup>  |
| 8    | List of Subsidiaries <sup>(6)</sup>   |
| 12.1 | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Exchange Act*  |
| 12.2 | Certification of the 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 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* |
| 13.2 | Certification of the 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 <sup>(6)</sup>  |
| 15.2 | Consent of Levy Cohen and Co. <sup>(6)</sup>  |
| 15.3 | Consent of Levy Cohen and Co. <sup>(6)</sup>  |
| 15.4 | Consent of KDA Audit Corporation <sup>(6)</sup>   |
| 15.5 | Consent of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global*  |
| 15.6 | Consent of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global*  |

**Exhibit**

**No.** \_\_\_\_\_

**99.1** Audited Financial Statements of Magic Software Enterprises Ltd.\*

**99.2** Audited Financial Statements of Sapiens International Corporation N.V.\*

\*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 Exhibit 99.1 to the report on Form 6-K filed by the registrant with the Securities and Exchange Commission on January 18, 2012.

(3) Incorporated by reference to Exhibit 99.2 to the report on Form 6-K filed by the registrant with the Securities and Exchange Commission on January 18, 2012.

(4) 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.

(5) Incorporated by reference to the annual report on Form 20-F for the 2013 fiscal year filed by the registrant with the Securities and Exchange Commission on April 30, 2014.

(6) Incorporated by reference to the annual report on Form 20-F for the 2014 fiscal year filed by the registrant with the Securities and Exchange Commission on April 30, 2015.

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**SIGNATURES**

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

FORMULA SYSTEMS (1985) LTD.

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

June 30, 2015  
Date

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## EXHIBIT INDEX

### Exhibit No.

|             |   |
|-------------|---|
| <b>1.1</b>  | Memorandum of Association <sup>(1)</sup>  |
| <b>1.2</b>  | Amended and Restated Articles of Association, as adopted by Formula Systems (1985) Ltd. on January 8, 2012 <sup>(2)</sup>   |
| <b>2.1</b>  | Depository Agreement by and among Formula Systems (1985) Ltd., Bank of New York Mellon and the holders of the American Depository Shares of Formula Systems (1985) Ltd. <sup>(1)</sup>                          |
| <b>4.1</b>  | Form of Letter of Indemnification for officers and directors, adopted by Formula Systems (1985) Ltd. on January 8, 2012 <sup>(3)</sup>  |
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| <b>15.6</b> | Consent of Kost, Forer, Gabbay & Kasierer, A Member of Ernst & Young Global*  |
| <b>99.1</b> | Audited Financial Statements of Magic Software Enterprises Ltd.*  |
| <b>99.2</b> | Audited Financial Statements of Sapiens International Corporation N.V.*   |

\*Filed herewith.

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

<sup>(2)</sup> Incorporated by reference to Exhibit 99.1 to the report on Form 6-K filed by the registrant with the Securities and Exchange Commission on January 18, 2012.

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<sup>(4)</sup> 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.

<sup>(5)</sup> Incorporated by reference to the annual report on Form 20-F for the 2013 fiscal year filed by the registrant with the Securities and Exchange Commission on April 30, 2014.

<sup>(6)</sup> Incorporated by reference to the annual report on Form 20-F for the 2014 fiscal year filed by the registrant with the Securities and Exchange Commission on April 30, 2015.

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**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER**  
**PURSUANT TO RULE 13a-14(a)/RULE 15d-14(a) UNDER**  
**THE EXCHANGE ACT**

I, Guy Bernstein, certify that:

1. I have reviewed this Amendment No. 1 to the Annual Report on Form 20-F for the year ended December 31, 2014 of Formula Systems (1985) Ltd. (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report; and
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report.

Date: June 30, 2015

/s/ Guy Bernstein  
Guy Bernstein  
Chief Executive Officer

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**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER**  
**PURSUANT TO RULE 13a-14(a)/RULE 15d-14(a) UNDER**  
**THE EXCHANGE ACT**

I, Asaf Berenstin, certify that:

1. I have reviewed this Amendment No. 1 to the Annual Report on Form 20-F for the year ended December 31, 2014 of Formula Systems (1985) Ltd. (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report; and
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report.

Date: June 30, 2015

/s/ Asaf Berenstin  
Asaf Berenstin  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT  
TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with Amendment No. 1 to the Annual Report of Formula Systems (1985) Ltd. (the “Company”) on Form 20-F for the period ending December 31, 2014, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Guy Bernstein, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: June 30, 2015

/s/ Guy Bernstein  
Guy Bernstein  
Chief Executive Officer

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**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT  
TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with Amendment No. 1 to the Annual Report of Formula Systems (1985) Ltd. (the "Company") on Form 20-F for the period ending December 31, 2014, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Asaf Berenstin, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: June 30, 2015

/s/ Asaf Berenstin  
Asaf Berenstin  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-156686) of our report dated April 21, 2015, with respect to the consolidated financial statements of Magic Software Enterprises Ltd. included in this Amendment No. 1 to the Annual Report on Form 20-F of Formula Systems (1985) Ltd. for the year ended December 31, 2014.

Tel- Aviv, Israel  
June 30, 2015

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

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**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-156686) of our report dated March 29, 2015, with respect to the consolidated financial statements of Sapiens International Corporation N.V. included in this Amendment No. 1 to the Annual Report on Form 20-F of Formula Systems (1985) Ltd. for the year ended December 31, 2014.

Tel- Aviv, Israel  
June 30, 2015

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

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## MAGIC SOFTWARE ENTERPRISES LTD. AND ITS SUBSIDIARIES

## CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2014

U.S. DOLLARS IN THOUSANDS

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and the Board of Directors of  
MAGIC SOFTWARE ENTERPRISES LTD.**

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. ("the Company") and its subsidiaries as of December 31, 2013 and 2014, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect total assets of 7% and 4% as of December 31, 2013 and 2014, respectively, and total revenues of 16%, 14% and 11% for the years ended December 31, 2012, 2013 and 2014, respectively of the related consolidated totals. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those subsidiaries, is based solely on the reports of the other auditors.

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

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2013 and 2014, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

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, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated April 21, 2015 expressed an unqualified opinion thereon.

Tel-Aviv, Israel  
April 21, 2015

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



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and the Board of Directors of  
MAGIC SOFTWARE ENTERPRISES LTD.**

We have audited Magic Software Enterprises Ltd. ("the Company") internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) ("the COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the COSO criteria.





We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company and its subsidiaries as of December 31, 2013 and 2014, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2014 and our report dated April 21, 2015 expressed an unqualified opinion thereon.

Tel-Aviv, Israel  
April 21, 2015

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

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

|   | December 31,      |                   |
|---|-------------------|-------------------|
|   | 2013              | 2014              |
| <b>ASSETS</b>   |                   |                   |
| <b>CURRENT ASSETS:</b>  |                   |                   |
| Cash and cash equivalents   | \$ 35,134         | \$ 72,515         |
| Available-for-sale marketable securities (Note 4)   | 854               | 11,915            |
| Trade receivables (net of allowance for doubtful accounts of \$ 3,313 and \$ 2,380 at December 31, 2013 and 2014, respectively) | 31,976            | 40,358            |
| Other accounts receivable and prepaid expenses (Note 6)   | 5,209             | 3,973             |
| <b>Total current assets</b>   | <b>73,173</b>     | <b>128,761</b>    |
| <b>LONG-TERM RECEIVABLES:</b>   |                   |                   |
| Severance pay fund  | 403               | 1,426             |
| Long term deferred tax asset (Note 12)  | 1,674             | 1,583             |
| Other long-term receivables   | 2,118             | 2,376             |
| <b>Total long-term receivables</b>  | <b>4,195</b>      | <b>5,385</b>      |
| PROPERTY AND EQUIPMENT, NET (Note 7)  | 1,773             | 2,005             |
| INTANGIBLE ASSETS, NET (Note 8)   | 32,549            | 32,543            |
| GOODWILL (Note 9)   | 55,313            | 55,490            |
| <b>Total assets</b>   | <b>\$ 167,003</b> | <b>\$ 224,184</b> |

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

CONSOLIDATED BALANCE SHEETS

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

|  | December 31,      |                   |
|--|-------------------|-------------------|
|  | 2013              | 2014              |
| <b>LIABILITIES AND EQUITY</b>  |                   |                   |
| <b>CURRENT LIABILITIES:</b>  |                   |                   |
| Short term debt (Note 11)  | \$ 1,055          | \$ 2,853          |
| Trade payables   | 4,149             | 3,861             |
| Accrued expenses and other accounts payable (Note 10)  | 16,937            | 15,013            |
| Deferred tax liability (Note 12)   | 2,567             | 760               |
| Deferred revenues  | 3,294             | 3,431             |
| <b>Total current liabilities</b>   | <b>28,002</b>     | <b>25,918</b>     |
| <b>ACCRUED SEVERANCE PAY</b>   | <b>1,275</b>      | <b>2,562</b>      |
| <b>LONG TERM LIABILITIES:</b>  |                   |                   |
| Long term debt (Note 11)   | 2,274             | 490               |
| Liabilities due to acquisition activities and other (Note 3)   | 1,396             | 474               |
| Long term deferred tax liability (Note 12)   | 2,204             | 4,086             |
|  | <b>5,874</b>      | <b>5,050</b>      |
| <b>COMMITMENTS AND CONTINGENCIES (Note 15)</b>   |                   |                   |
| <b>REDEEMABLE NON-CONTROLLING INTEREST</b>   | <b>2,721</b>      | <b>2,930</b>      |
| <b>EQUITY (Note 13):</b>   |                   |                   |
| Magic Software Enterprises equity:   |                   |                   |
| Share capital:   |                   |                   |
| Ordinary shares of NIS 0.1 par value - Authorized: 50,000,000 shares at December 31, 2013 and 2014; Issued and Outstanding: 37,155,355 and 44,174,217 shares at December 31, 2013 and 2014, respectively | 826               | 1,029             |
| Additional paid-in capital   | 127,060           | 182,114           |
| Accumulated other comprehensive loss   | (172)             | (5,347)           |
| Accumulated (deficit) earnings   | 430               | 7,269             |
| <b>Total Magic Software Enterprises equity</b>   | <b>128,144</b>    | <b>185,065</b>    |
| Non-controlling interests  | 987               | 2,659             |
| <b>Total equity</b>  | <b>129,131</b>    | <b>187,724</b>    |
| <b>Total liabilities, redeemable non-controlling interest and equity</b>   | <b>\$ 167,003</b> | <b>\$ 224,184</b> |

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

**CONSOLIDATED STATEMENTS OF INCOME**

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

|  | Year ended December 31, |                  |                  |
|--|-------------------------|------------------|------------------|
|  | 2012                    | 2013             | 2014             |
| Revenues (Note 17):  |                         |                  |                  |
| Software   | \$ 23,684               | \$ 23,254        | \$ 25,351        |
| Maintenance and technical support  | 22,384                  | 22,685           | 22,780           |
| Consulting services  | 80,312                  | 99,019           | 116,173          |
| <b>Total revenues</b>  | <b>126,380</b>          | <b>144,958</b>   | <b>164,304</b>   |
| Cost of revenues:  |                         |                  |                  |
| Software   | 7,439                   | 6,648            | 7,646            |
| Maintenance and technical support  | 3,238                   | 2,949            | 2,921            |
| Consulting services  | 62,716                  | 76,296           | 89,160           |
| <b>Total cost of revenues</b>  | <b>73,393</b>           | <b>85,893</b>    | <b>99,727</b>    |
| Gross profit   | 52,987                  | 59,065           | 64,577           |
| Operating costs and expenses:  |                         |                  |                  |
| Research and development, net (Note 14a)   | 2,947                   | 3,706            | 4,750            |
| Selling and marketing  | 22,990                  | 23,066           | 24,580           |
| General and administrative   | 10,642                  | 13,166           | 14,521           |
| <b>Total operating costs and expenses</b>  | <b>36,579</b>           | <b>39,938</b>    | <b>43,851</b>    |
| Operating income   | 16,408                  | 19,127           | 20,726           |
| Financial income (expense), net (Note 14b)   | 10                      | (684)            | (1,786)          |
| Other income (expense), net  | 136                     | (12)             | (67)             |
| Income before taxes on income  | 16,554                  | 18,431           | 18,873           |
| Taxes on income (Note 12)  | 94                      | 1,575            | 2,307            |
| Net income   | 16,460                  | 16,856           | 16,566           |
| Net income attributable to redeemable non-controlling interests                            | 184                     | 546              | 425              |
| Net income attributable to non-controlling interests                                       | 93                      | 430              | 621              |
| <b>Net income attributable to Magic Software Enterprises Shareholders</b>                  | <b>\$ 16,183</b>        | <b>\$ 15,880</b> | <b>\$ 15,520</b> |
| Net earnings per share attributable to Magic Software Enterprises' shareholders (Note 16): |                         |                  |                  |
| Basic and diluted earnings per share   | \$ 0.44                 | \$ 0.43          | \$ 0.36          |

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

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

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

|   | Year ended December 31, |                  |                  |
|---|-------------------------|------------------|------------------|
|   | 2012                    | 2013             | 2014             |
| Net income  | \$ 16,460               | \$ 16,856        | \$ 16,566        |
| Other comprehensive income (loss), net of tax                                 |                         |                  |                  |
| Foreign currency translation adjustments, net                                 | (621)                   | 495              | (5,469)          |
| Unrealized gain from derivative instruments, net                              | 29                      | -                | -                |
| Unrealized loss (gain) from available-for-sale securities                     | 28                      | (35)             | (259)            |
| Total other comprehensive income (loss), net of tax                           | (564)                   | 460              | (5,728)          |
| Total comprehensive income  | 15,896                  | 17,316           | 10,838           |
| Comprehensive income attributable to redeemable non-controlling interests     | 157                     | 807              | 51               |
| Comprehensive income attributable to non-controlling interests                | 96                      | 476              | 442              |
| Comprehensive income attributable to Magic Software Enterprises' shareholders | <u>\$ 15,643</u>        | <u>\$ 16,033</u> | <u>\$ 10,345</u> |

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

STATEMENTS OF CHANGES IN EQUITY  
U.S. dollars in thousands (except per share data)

|  | Number of<br>Shares | Share<br>capital<br>amount | Attributable to the Company's shareholders |  |                        |        | Non<br>controlling<br>interests | Total<br>equity |
|--|---------------------|----------------------------|--|--|------------------------|--------|---------------------------------|-----------------|
|  |                     |                            | Additional<br>paid-in<br>capital           | Accumulated<br>other<br>comprehensive<br>income (loss) | Accumulated<br>deficit |        |                                 |                 |
| Balance as of January 1, 2012                                  | 36,490,020          | \$ 808                     | \$ 124,616                                 | \$ (19)  | \$ (20,249)            | \$ 469 | \$ 105,625                      |                 |
| Exercise of stock options                                      | 136,708             | 3                          | 306  | -  | -                      | -      | 309                             |                 |
| Stock-based compensation expenses                              | -                   | -                          | 515  | -  | -                      | -      | 515                             |                 |
| Dividend   | -                   | -                          | -  | -  | (3,661)                | -      | (3,661)                         |                 |
| Acquisition of non-controlling interests in Xsell (see Note 3) | -                   | -                          | (149)                                      | -  | -                      | (165)  | (314)                           |                 |
| Other comprehensive income                                     | -                   | -                          | -  | (567)  | -                      | 3      | (564)                           |                 |
| Net income   | -                   | -                          | -  | -  | 16,183                 | 268    | 16,451                          |                 |
| Balance as of December 31, 2012                                | 36,626,728          | 811                        | 125,288                                    | (586)  | (7,727)                | 575    | 118,361                         |                 |
| Exercise of stock options                                      | 528,627             | 15                         | 1,447                                      | -  | -                      | -      | 1,462                           |                 |
| Stock-based compensation expenses                              | -                   | -                          | 325  | -  | -                      | -      | 325                             |                 |
| Dividend   | -                   | -                          | -  | -  | (7,723)                | (64)   | (7,787)                         |                 |
| Other comprehensive income                                     | -                   | -                          | -  | 414  | -                      | 46     | 460                             |                 |
| Net income   | -                   | -                          | -  | -  | 15,880                 | 430    | 16,310                          |                 |
| Balance as of December 31, 2013                                | 37,155,355          | 826                        | 127,060                                    | (172)  | 430                    | 987    | 129,131                         |                 |
| Issuance of shares   | 6,903,141           | 201                        | 54,525                                     | -  | -                      | -      | 54,726                          |                 |
| Exercise of stock options                                      | 115,721             | 2                          | 202  | -  | -                      | -      | 204                             |                 |
| Stock-based compensation expenses                              | -                   | -                          | 327  | -  | -                      | 1,230  | 1,557                           |                 |
| Dividend   | -                   | -                          | -  | -  | (8,681)                | -      | (8,681)                         |                 |
| Other comprehensive income                                     | -                   | -                          | -  | (5,175)  | -                      | (179)  | (5,354)                         |                 |
| Net income   | -                   | -                          | -  | -  | 15,520                 | 621    | 16,141                          |                 |
| Balance as of December 31, 2014                                | 44,174,217          | 1,029                      | 182,114                                    | (5,347)  | 7,269                  | 2,659  | 187,724                         |                 |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

|  | Year ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2012                    | 2013      | 2014      |
| <b>Cash flows from operating activities:</b>   |                         |           |           |
| Net income   | \$ 16,460               | \$ 16,856 | \$ 16,566 |
| Adjustments to reconcile net income to net cash provided by operating activities:              |                         |           |           |
| Depreciation and amortization  | 7,444                   | 8,380     | 8,660     |
| Interest expenses related to liabilities in connection with acquisitions                       | 48                      | -         | -         |
| Accrued severance pay, net   | 8                       | -         | -         |
| Loss on sale of property and equipment   | -                       | 10        | -         |
| Stock-based compensation expenses  | 515                     | 325       | 1,557     |
| Amortization of marketable securities premium, accretion of discount                           | -                       | -         | 62        |
| Gain on sale of subsidiary's operation   | (136)                   | -         | -         |
| Decrease (increase) in trade receivables, net  | 11                      | 473       | (9,378)   |
| Decrease (increase) in other long term and short term accounts receivable and prepaid expenses | 145                     | (397)     | (23)      |
| Increase in trade payables   | 780                     | (700)     | (342)     |
| Increase (decrease) in accrued expenses and other accounts payable                             | (2,279)                 | (1,589)   | (303)     |
| Increase (decrease) in deferred revenues   | (1,131)                 | (1,765)   | 191       |
| Change in deferred income taxes, net   | 1,083                   | 687       | 1,204     |
| Net cash provided by operating activities  | 22,948                  | 22,280    | 18,194    |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

|  | Year ended December 31, |                  |                  |
|--|-------------------------|------------------|------------------|
|  | 2012                    | 2013             | 2014             |
| <b>Cash flows from investing activities:</b>                     |                         |                  |                  |
| Capitalized software development costs                           | (4,969)                 | (4,713)          | (4,267)          |
| Purchase of property and equipment                               | (510)                   | (497)            | (993)            |
| Cash paid in conjunction with acquisitions, net of acquired cash | (7,627)                 | (16,557)         | (9,363)          |
| Proceeds from sale of subsidiary's operation                     | 136                     | -                | -                |
| Proceeds from sale of property and equipment                     | -                       | 60               | -                |
| Proceeds from maturity of marketable securities                  | 343                     | -                | 596              |
| Proceeds from short-term bank deposits                           | 3,601                   | -                | -                |
| Change in loans to employees and other deposits ,net             | (34)                    | -                | (58)             |
| Investment in marketable securities                              | -                       | -                | (11,976)         |
| Investment in short-term bank deposit                            | (1,366)                 | -                | -                |
| Net cash used in investing activities                            | <u>(10,426)</u>         | <u>(21,707)</u>  | <u>(26,061)</u>  |
| <b>Cash flows from financing activities:</b>                     |                         |                  |                  |
| Proceeds from exercise of options by employees                   | 309                     | 1,462            | 204              |
| Issuance of Ordinary shares, net                                 | -                       | -                | 54,726           |
| Dividend paid  | (3,661)                 | (7,787)          | (8,681)          |
| Short-term credit, net   | 14                      | (47)             | 2,974            |
| Purchase of non-controlling interest                             | (87)                    | (168)            | -                |
| Long term loan received  | -                       | 3,307            | -                |
| Repayment of long-term loans                                     | -                       | (95)             | (2,905)          |
| Net cash used in financing activities                            | <u>(3,425)</u>          | <u>(3,328)</u>   | <u>46,318</u>    |
| Effect of exchange rate changes on cash and cash equivalents     | <u>(64)</u>             | <u>145</u>       | <u>(1,070)</u>   |
| Increase (decrease) in cash and cash equivalents                 | 9,033                   | (2,610)          | 37,381           |
| Cash and cash equivalents at the beginning of the year           | <u>28,711</u>           | <u>37,744</u>    | <u>35,134</u>    |
| Cash and cash equivalents at end of the year                     | <u>\$ 37,744</u>        | <u>\$ 35,134</u> | <u>\$ 72,515</u> |

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



**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

|  | Year ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2012                    | 2013     | 2014     |
| <u>Supplementary information on investing and financing activities not involving cash flows:</u> |                         |          |          |
| Non-cash activities:   |                         |          |          |
| Deferred acquisition payment   | \$ 3,103                | \$ 1,581 | \$ 250   |
| Contingent acquisition payment   | \$ 1,192                | \$ 3,981 | \$ -     |
| <u>Supplemental disclosure of cash flow activities:</u>  |                         |          |          |
| <u>Cash paid during the year for:</u>  |                         |          |          |
| Income taxes   | \$ 1,250                | \$ 1,519 | \$ 1,601 |
| Interest   | \$ 17                   | \$ 34    | \$ 74    |

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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**NOTE 1:- GENERAL**

Magic Software Enterprises Ltd., an Israeli company, and its subsidiaries ("the Group") is a global provider of software platforms and professional services that accelerate the planning, development, deployment and integration of on-premise, mobile and cloud business applications ("the Magic technology"). Magic technology enables enterprises to accelerate the process of delivering business solutions that meet current and future needs and allow customers to dramatically improve their business performance and return on investment. To complement its software products and to increase its traction with customers, the Group also offers a complete portfolio of IT professional services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, communications services and solutions, and supplemental staffing services. The Company reports its results on the basis of two reportable business segments: software services (which include proprietary and non-proprietary software and related services) and IT professional services (see Note 17 for further details). The principal markets of the Group are Europe, United States, Japan and Israel (see Note 17).

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

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

**Use of estimates**

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

**Financial statements in United States dollars**

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

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

**Principles of consolidation**

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

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

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

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

|   |              |
|---|--------------|
| January 1, 2014   | 2,721        |
| Net income attributable to redeemable non-controlling interests | 425          |
| Non-controlling interest as part of acquisitions                | 158          |
| Foreign currency translation adjustments                        | (374)        |
| December 31, 2014   | <u>2,930</u> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

**Cash and cash equivalents**

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

Cash and cash equivalent includes amounts held primarily in NIS, U.S. dollars, Euro, Japanese Yen and British Pound.

**Short-term deposits and restricted deposits**

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

**Marketable securities**

The Company accounts for investments in marketable securities in accordance with ASC No. 320, "Investments – Debt and Equity Securities". Management determines the appropriate classification of its investments at the time of purchase and reevaluates such determinations at each balance sheet date. The Company classifies all of its marketable securities as available for sale. Available for sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported in "accumulated other comprehensive income (loss)" in equity. Realized gains and losses on sale of investments are included in "financial income, net" and are derived using the specific identification method for determining the cost of securities.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest on securities is included in "financial income, net".

The Company recognizes an impairment charge when a decline in the fair value of its investments in debt securities below the cost basis of such securities is judged to be other-than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period and the Company's intent to sell, including whether it is more likely than not that the Company will be required to sell the investment before recovery of cost basis. For securities that are deemed other-than-temporarily impaired, the amount of impairment is recognized in "net gain (impairment net of gains) on sale of marketable securities previously impaired" in the statements of income and is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

**Property and equipment, net**

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

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

**Business combinations**

The Company accounts for business combinations under ASC 805, "Business Combinations". ASC 805 requires recognition of assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. As required by ASC 820, "Fair Value Measurements and disclosures" the Company applies assumptions that marketplace participants would consider in determining the fair value of assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in earnings.

**Variable interest entities**

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

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

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

**Research and development costs**

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

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

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

Capitalized software costs are amortized on a product by product basis by the straight-line method over the estimated useful life of the software product (between 4-5 years). The Company assesses the recoverability of these intangible assets on a regular basis by determining whether the amortization of the asset over its remaining economical useful life can be recovered through undiscounted future operating cash flows from the specific software product sold. During the years ended December 31, 2012, 2013 and 2014, no such unrecoverable amounts were identified.

**Long-Lived Assets**

The Company long-lived, non-current assets are comprised mainly of goodwill, identifiable intangible assets and property, plants and equipment.

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

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

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

During the years ended December 31, 2012, 2013 and 2014, no impairment was identified.

**Goodwill**

Goodwill represents the excess of the purchase price in a business combination over the fair value of the net tangible and intangible assets acquired. Under ASC 350, "Intangibles - Goodwill and Other", goodwill is subject to an annual impairment test or more frequently if impairment indicators are present. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. As of December 31, 2014, the Company operates in four reporting units within its operating segments.

Goodwill reflects the excess of the consideration paid or transferred plus the fair value of contingent consideration and any non-controlling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired. The goodwill impairment test is performed according to the following principles:

An initial qualitative assessment of the likelihood of impairment may be performed. If this step does not result in a more likely than not indication of impairment, no further impairment testing is required. If it does result in a more likely than not indication of impairment, the impairment test is performed.

In step one of the impairment test, the company compares the fair value of the reporting units to the carrying value of net assets allocated to the reporting units. If the fair value of the reporting unit exceeds the carrying value of the net assets allocated to that unit, goodwill is not impaired, and no further testing is required. Otherwise, the company must perform the second step of the impairment test to measure the amount of the impairment.

In the second step, the reporting unit's fair value is allocated to all the assets and liabilities of the reporting unit, including any unrecognized intangible assets, in a hypothetical analysis that simulates the business combination principles to derive an implied goodwill value. If the implied fair value of the reporting unit's goodwill is less than its carrying value, the difference is recorded as impairment.

The Company performed an annual impairment tests as of December 31, of each of 2012, 2013 and 2014 and did not identify any impairment losses (see Note 9).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

**Revenue recognition**

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

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

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

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

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

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

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



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

Arrangements that include professional services bundled with licensed software and other software related elements, are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential to the software, revenues under the arrangement are recognized using contract accounting based on ASC 605-35, "Construction-Type and Production-Type Contracts", on a percentage of completion method based on inputs measures. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss for the entire contract. During the years ended December 31, 2012, 2013 and 2014, no such estimated losses were identified.

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

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

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

**Severance pay**

The Company's and its Israeli subsidiary's obligation for severance pay with respect to their Israeli employees (for the period for which the employees were not included under Section 14 of the Severance Pay Law, 1963) is calculated pursuant to the Israeli Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date, and are presented on an undiscounted basis (referred to as the "Shut Down Method"). Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's obligation for all of its Israeli employees is fully provided for by monthly deposits with insurance policies and by an accrual.

The Group has a number of savings plans in the United States that qualify under Section 401(k) of the Internal Revenue Code. U.S employees may contribute up to 100% of their pretax salary, but not more than statutory limits. Matching contributions are discretionary and are up to 3% of the participants contributions. When contributions are granted, they are invested in proportion to each participant's voluntary contributions in the investment options provided under the plan.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

Severance expenses for the years ended December 31, 2012, 2013 and 2014 amounted to approximately \$ 829, \$ 1,371 and \$ 1,673, respectively.

**Advertising expenses**

Advertising expenses are charged to selling and marketing expenses, as incurred. Advertising expenses for the years ended December 31, 2012, 2013 and 2014 amounted to \$ 556, \$ 306 and \$ 466, respectively.

**Income taxes**

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

**Basic and diluted net earnings per share**

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

A portion of the outstanding stock options have been excluded from the calculation of the diluted earnings per share because such securities are anti-dilutive. The total weighted average number of Ordinary shares related to the outstanding options excluded from the calculations of diluted earnings per share was 669,887, 536,877 and 35,010 for the years ended December 31, 2012, 2013 and 2014, respectively.

**Stock-based compensation**

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

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

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

|   | <u>2013</u> | <u>2014</u> |
|---|-------------|-------------|
| Dividend yield                            | 0%          | 0%          |
| Expected volatility                       | 32% - 59%   | 32% - 59%   |
| Risk-free interest rate                   | 0.1% - 2.6% | 0.1% - 2.6% |
| Expected forfeiture (employees)           | -           | -           |
| Expected forfeiture (executives)          | -           | -           |
| Contractual term of up to                 | 10 years    | 10 years    |
| Suboptimal exercise multiple (employees)  | 2           | -           |
| Suboptimal exercise multiple (executives) | 2           | 2           |

During the years ended December 31, 2012, 2013 and 2014, the Company recognized stock-based compensation expense related to employee stock options in the amount of \$ 515, \$ 325 and \$ 1,557, respectively, as follows:

|  | <u>Year ended December 31,</u> |               |                 |
|--|--------------------------------|---------------|-----------------|
|  | <u>2012</u>                    | <u>2013</u>   | <u>2014</u>     |
| Cost of revenue                        | \$ 16                          | \$ 11         | \$ 30           |
| Research and development               | 114                            | 67            | 29              |
| Selling and marketing                  | 82                             | 85            | 220             |
| General and administrative             | 303                            | 162           | 1,278           |
| Total stock-based compensation expense | <u>\$ 515</u>                  | <u>\$ 325</u> | <u>\$ 1,557</u> |

**Concentrations of credit risk**

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

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

Trade receivables of the Company and its subsidiaries are derived from sales to customers located primarily in the United States, Europe, Japan, South Africa and Israel. The Company performs ongoing credit evaluations of its customers and excluding 2013 to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. The expense related to doubtful accounts for the years ended December 31, 2012, 2013 and 2014 was \$ 420, \$ 1,285 and \$ 735, respectively.

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

**Fair value measurements**

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

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

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

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

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

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

**Comprehensive income (loss)**

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

**Derivative instruments**

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

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

The notional principal of foreign exchange contracts to purchase NIS with U.S. dollars was \$ 0 and \$ 1,736 as of December 31, 2013 and 2014, respectively.

At December 31, 2014, the Company did not have any cash flow hedges.

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

|                                       | Fair values of derivative instruments               |                    |      |
|---------------------------------------|---|--------------------|------|
|                                       | Assets  | December 31,       |      |
|                                       |   | Balance sheet item | 2013 |
| <b>Assets</b>                         |   |                    |      |
| Derivatives not designated as hedging | "Other accounts receivable and prepaid expenses" \$ | -                  | \$ 9 |
| Total derivatives                     |   | \$ -               | \$ 9 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

|  | Statements<br>of<br>income item | Gain (loss)<br>recognized in the<br>statements of income |               |              |
|--|---------------------------------|--|---------------|--------------|
|  |                                 | Year ended December 31,                                  |               |              |
|  |                                 | 2012   | 2013          | 2014         |
| Derivatives not designated as hedging: |                                 |  |               |              |
| Foreign exchange forward contracts     | "Financial expenses, net"       | 245  | 139           | 24           |
| Total derivatives                      |                                 | <u>\$ 245</u>  | <u>\$ 139</u> | <u>\$ 24</u> |

**Reclassification**

Certain amounts in prior years' financial statements have been reclassified to conform with the current year's presentation. The reclassification had no effect on previously reported net income, equity or cash flow.

**Recently Issued Accounting Pronouncement:**

In August 2014, the Financial Accounting Standards Board ("FASB") issued amended guidance related to disclosure of uncertainties about an entity's ability to continue as a going concern. The new guidance requires management to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern and, as necessary, to provide related footnote disclosures. The guidance has an effective date of December 31, 2016.

In May 2014, Financial Accounting Standards Board ("FASB") issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)", a comprehensive new revenue recognition standard that will supersede existing revenue guidance under US GAAP and IFRS ("ASU 2014-09"). ASU 2014-09's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for annual periods beginning after December 15, 2016, including interim periods within that period. Early adoption is not permitted under US GAAP. The Company is currently evaluating the method of adoption, as well as the effect that adoption of this ASU will have 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.)**

In April 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-08 (ASU 2014-08) "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. The new guidance limits the presentation of discontinued operations to business circumstances when the disposal of the business operation represents a strategic shift that has had or will have a major effect on operations and financial results. This guidance is effective for fiscal years beginning January 1, 2015. The company believes that the adoption of this new standard will not materially impact its consolidated financial statements.

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

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

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

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

|                         |                      |
|-------------------------|----------------------|
| Net liabilities         | \$ (3,248)           |
| Intangible assets       | 7,251                |
| Goodwill                | <u>8,702</u>         |
| <br>Net assets acquired | <br><u>\$ 12,705</u> |

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

- b. In July 2012, the Company acquired an 80% interest in Comm-IT Group, (including "Comm-IT Technology Solutions" and "Comm-IT Software"), a software and systems development house that specializes in providing advanced IT and communications services and solutions, for a total consideration of \$ 8,933, of which \$ 4,990 was paid upon closing and the remaining \$ 3,943 is to be paid during the next two years, of which, \$ 1,192 is contingent upon the acquired business meeting certain operational targets in 2012 and 2013, and \$ 2,751 in deferred payments. The Purchaser and the seller hold mutual Call and Put options respectively for the remaining 20% interest in the group. As a result of the Put option, the Company recorded redeemable non-controlling interest in the amount of \$ 1,750. In March 2014, the paid the sellers the remaining deferred payments.

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

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

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

On May 2013 the company finalized the process of identifying the tangible and intangible assets for its acquisition. The following table summarize the fair value of the assets and liabilities acquired:

|                             | <b>As reported<br/>on December<br/>31, 2012</b> | <b>Adjustment</b> | <b>Modified</b> |
|-----------------------------|---|-------------------|-----------------|
| Net assets                  | \$ 1,219  | \$ 14             | \$ 1,233        |
| Non-controlling interest    | (1,880)   | 130               | (1,750)         |
| Intangible assets           | 3,873   | 397               | 4,270           |
| Goodwill                    | 5,809   | 439               | 6,248           |
| Deferred tax liability, net | -   | (1,068)           | (1,068)         |
| <b>Net assets acquired</b>  | <b>\$ 9,021</b>                                 | <b>\$ (88)</b>    | <b>\$ 8,933</b> |

- c. On February 26, 2013, the Company purchased Pilat Europe Limited Ltd. and Pilat (North America) Inc. which provides custom human capital management solutions, for a total consideration of \$ 1,233. The Company believes the acquisition will broaden its application product portfolio, customer base and strengthen its presence in numerous global markets. Acquisition related costs were immaterial. The acquisition was accounted for by the purchase method. The results of operations of these entities were included in the consolidated financial statements of the Company commencing March 1, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                              |                 |
|------------------------------|-----------------|
| Net assets                   | \$ 490          |
| Intangible assets            | 715             |
| <b>Total assets acquired</b> | <b>\$ 1,205</b> |

- d. On May 16, 2013, the Company purchased Valinor Ltd, a consulting company specializing in project and product consultation, installation and implementation of databases for a total consideration of \$ 1,618, of which \$ 339 was paid upon closing, \$ 339 was paid in November 2013, \$340 paid on May 25, 2014, and \$ 600 is contingently payable upon the business meeting certain operational targets in 2013 and 2014. The amount related to operational targets of 2013 was paid in September 2014. On December 2013 the company increased the total consideration according to 2013 results by \$230 recorded in the Company's statement of operations. The Company believes the acquisition will broaden its professional service offering to its existing and new customers in the fields of projects and product consultation and installation and implementation of databases. Acquisition related costs were immaterial.

**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 acquisition was accounted for by the purchase method.

The results of operations of these entities were included in the consolidated financial statements of the Company commencing May 15, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                              |           |                     |
|------------------------------|-----------|---------------------|
| Net assets                   | \$        | 119                 |
| Intangible assets            |           | 464                 |
| Goodwill                     |           | <u>1,035</u>        |
| <b>Total assets acquired</b> | <b>\$</b> | <b><u>1,618</u></b> |

- e. On May 30, 2013, the Company purchased Dario Solutions IT Ltd, a consulting company specializing in integration services of Microsoft products in enterprise IT environments for a total consideration of \$ 3,723, of which \$ 1,100 was paid upon closing, \$ 906 is to be paid by February 28, 2014 and the remaining \$ 1,717 is contingently payable upon the business meeting certain operational targets in 2013, 2014 and 2015. The amount related to operational targets of 2013 was paid in September 2014. On September 2014 the company decreased the total consideration according to 2014 results by \$997 recorded in the Company's statement of operations. The company believes the acquisition will complement the company's professional services offering to its existing and new customers in the field of software integration and advanced on target IT solutions for large and mid- range customers. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method.

The results of operations of these entities were included in the consolidated financial statements of the Company commencing June 1, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                              |           |                     |
|------------------------------|-----------|---------------------|
| Net Assets                   | \$        | 371                 |
| Intangible assets            |           | 707                 |
| Goodwill                     |           | <u>2,645</u>        |
| <b>Total assets acquired</b> | <b>\$</b> | <b><u>3,723</u></b> |

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.)

- f. On November 11, 2013 the Company acquired the operations of Allstates Technical Services, LLC, a US-based full-service provider of consulting and staffing solutions for IT, Engineering and Telecom personnel, for a total consideration of \$10,963. The company believes the acquisition will broaden its existing US footprint and adds leading Fortune 500 companies to its customer base, making an important contribution to its growth strategy in the IT professional services operating segment. The results of operations were included in the consolidated financial statements of the Company commencing November 11, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                              |           |                      |
|------------------------------|-----------|----------------------|
| Net Assets                   | \$        | 3,063                |
| Intangible assets            |           | 2,874                |
| Goodwill                     |           | <u>5,026</u>         |
| <b>Total assets acquired</b> | <b>\$</b> | <b><u>10,963</u></b> |

- g. In addition, the Company acquired additional activities during the years ended December 31, 2013 and 2014, whose influence on the financial statements of the Company was immaterial, for a total consideration of \$ 0.9 million and \$ 0.7 million, respectively.
- h. On October 1, 2014 the Company acquired the operations Formula Telecom Solutions Ltd. (FTS), an Israel-based software vendor, for a total consideration of \$5,800. FTS specializes in the development, sale, service and support of Business Support Systems (BSS), including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications. The Company believes the acquisition will broaden its professional service offering to its existing and new customers in the fields of Business Support Systems, including convergent charging, billing, customer management and policy control. Acquisition related costs were immaterial. The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing October 1, 2014.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                              |           |                     |
|------------------------------|-----------|---------------------|
| Net Assets                   | \$        | (57)                |
| Intangible assets            |           | 2,951               |
| Goodwill                     |           | <u>2,906</u>        |
| <b>Total assets acquired</b> | <b>\$</b> | <b><u>5,800</u></b> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 4:- MARKETABLE SECURITIES

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

|   | December 31,   |                   |                  |               |                  |                   |                  |                  |
|---|----------------|-------------------|------------------|---------------|------------------|-------------------|------------------|------------------|
|   | 2013           |                   |                  |               | 2014             |                   |                  |                  |
|   | Amortized cost | Unrealized losses | Unrealized gains | Market value  | Amortized cost   | Unrealized losses | Unrealized gains | Market value     |
| Available-for-sale:                                   |                |                   |                  |               |                  |                   |                  |                  |
| Governmental bonds                                    | \$ 407         | \$ -              | \$ 3             | \$ 410        | \$ 11,916        | \$ (232)          | \$ -             | \$ 11,684        |
| Commercial bonds                                      | 190            | -                 | 25               | 215           | -                | -                 | -                | -                |
| Equity funds  | 119            | -                 | 110              | 229           | 116              | -                 | 115              | 231              |
| <b>Total available-for-sale marketable securities</b> | <b>\$ 716</b>  | <b>\$ -</b>       | <b>\$ 138</b>    | <b>\$ 854</b> | <b>\$ 12,032</b> | <b>\$ (232)</b>   | <b>\$ 115</b>    | <b>\$ 11,915</b> |

Marketable securities with contractual maturities from one to three years are as follows:

|                                | Amortized cost  | Unrealized gains (losses) |                 | Market value    |
|--------------------------------|-----------------|---------------------------|-----------------|-----------------|
|                                |                 | Gains                     | Losses          |                 |
| Due between one to three years | \$ 6,219        | \$ -                      | \$ (124)        | \$ 6,095        |
|                                | <u>\$ 6,219</u> | <u>\$ -</u>               | <u>\$ (124)</u> | <u>\$ 6,095</u> |

Marketable securities with contractual maturities from three to five years are as follows:

|                                 | Amortized cost  | Unrealized gains (losses) |                 | Market value    |
|---------------------------------|-----------------|---------------------------|-----------------|-----------------|
|                                 |                 | Gains                     | Losses          |                 |
| Due between three to five years | \$ 5,697        | \$ -                      | \$ (108)        | \$ 5,589        |
|                                 | <u>\$ 5,697</u> | <u>\$ -</u>               | <u>\$ (108)</u> | <u>\$ 5,589</u> |

The following is the change in the other comprehensive income of available-for-sale securities during 2013:

|   | Other comprehensive income |
|---|----------------------------|
| Other comprehensive income from available-for-sale securities as of January 1, 2013   | \$ 173                     |
| Unrealized loss from available-for-sale securities                                    | (35)                       |
| Other comprehensive income from available-for-sale securities as of December 31, 2013 | <u>\$ 138</u>              |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 4:- MARKETABLE SECURITIES (Cont.)

The following is the change in the other comprehensive income of available-for-sale securities during 2014:

|   | <b>Other<br/>comprehensive<br/>income</b> |
|---|---|
| Other comprehensive income from available-for-sale securities as of January 1, 2014   | \$ 138                                    |
| Unrealized losses from available-for-sale securities                                  | (259)                                     |
| Other comprehensive income from available-for-sale securities as of December 31, 2014 | <u>\$ (121)</u>                           |

NOTE 5:- FAIR VALUE MEASUREMENTS

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

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

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

|                             | <b>December 31, 2013</b>                        |                |                 |                 |
|-----------------------------|---|----------------|-----------------|-----------------|
|                             | <b>Fair value measurements using input type</b> |                |                 |                 |
|                             | <b>Level 1</b>                                  | <b>Level 2</b> | <b>Level 3</b>  | <b>Total</b>    |
| <b>Assets:</b>              |   |                |                 |                 |
| Government bonds            | \$ 410  | \$ -           | \$ -            | \$ 410          |
| Corporate bonds             | -   | 215            | -               | 215             |
| Equity fund                 | 229   | -              | -               | 229             |
| Total financial assets      | <u>\$ 639</u>                                   | <u>\$ 215</u>  | <u>\$ -</u>     | <u>\$ 854</u>   |
| <b>Liabilities:</b>         |   |                |                 |                 |
| Contingent consideration    | \$ -  | \$ -           | \$ 3,981        | \$ 3,981        |
| Total financial liabilities | <u>\$ -</u>                                     | <u>\$ -</u>    | <u>\$ 3,981</u> | <u>\$ 3,981</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5:- FAIR VALUE MEASUREMENTS (Cont.)

|                                    | December 31, 2014                        |                  |               |                  |
|------------------------------------|--|------------------|---------------|------------------|
|                                    | Fair value measurements using input type |                  |               |                  |
|                                    | Level 1                                  | Level 2          | Level 3       | Total            |
| <b>Assets:</b>                     |  |                  |               |                  |
| Corporate bonds                    | \$ -                                     | \$ 11,684        | \$ -          | \$ 11,684        |
| Equity fund                        | 231                                      | -                | -             | 231              |
| <b>Total financial assets</b>      | <u>\$ 231</u>                            | <u>\$ 11,684</u> | <u>\$ -</u>   | <u>\$ 11,915</u> |
| <b>Liabilities:</b>                |  |                  |               |                  |
| Contingent consideration           | \$ -                                     | \$ -             | \$ 382        | \$ 382           |
| <b>Total financial liabilities</b> | <u>\$ -</u>                              | <u>\$ -</u>      | <u>\$ 382</u> | <u>\$ 382</u>    |

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

|  | December 31,    |               |
|--|-----------------|---------------|
|  | 2013            | 2014          |
| Opening balance                                  | \$ 1,942        | \$ 3,981      |
| Increase in contingent consideration             | 2,459           | 250           |
| Payment in contingent consideration              | (750)           | (3,053)       |
| Change in fair value of contingent consideration | -               | (948)         |
| Amortization of interest                         | 330             | 152           |
| <b>Closing balance</b>                           | <u>\$ 3,981</u> | <u>\$ 382</u> |

NOTE 6:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

|                          | December 31,    |                 |
|--------------------------|-----------------|-----------------|
|                          | 2013            | 2014            |
| Prepaid expenses         | \$ 1,156        | \$ 1,159        |
| Government authorities   | 862             | 1,081           |
| Deferred tax assets, net | 1,949           | 554             |
| Restricted deposits      | 289             | 149             |
| Related parties          | 92              | 447             |
| Other                    | 861             | 583             |
|                          | <u>\$ 5,209</u> | <u>\$ 3,973</u> |



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- PROPERTY AND EQUIPMENT

|                                    | December 31,    |                 |
|------------------------------------|-----------------|-----------------|
|                                    | 2013            | 2014            |
| Cost:                              |                 |                 |
| Leasehold improvements             | \$ 546          | \$ 523          |
| Computers and peripheral equipment | 10,106          | 12,942          |
| Office furniture and equipment     | 2,639           | 2,620           |
| Motor vehicles                     | 98              | 177             |
| Software                           | 1,962           | 3,478           |
|                                    | <u>15,351</u>   | <u>19,740</u>   |
| Accumulated depreciation:          |                 |                 |
| Leasehold improvements             | 288             | 175             |
| Computers and peripheral equipment | 9,657           | 12,426          |
| Office furniture and equipment     | 1,947           | 1,985           |
| Motor vehicles                     | 68              | 133             |
| Software                           | 1,618           | 3,016           |
|                                    | <u>13,578</u>   | <u>17,735</u>   |
| Depreciated cost                   | <u>\$ 1,773</u> | <u>\$ 2,005</u> |

Depreciation expenses amounted to \$ 757, \$ 656 and \$ 675 for the years ended December 31, 2012, 2013 and 2014, respectively.

NOTE 8:- INTANGIBLE ASSETS

a. Intangible assets:

|                                   | December 31,     |                  |
|-----------------------------------|------------------|------------------|
|                                   | 2013             | 2014             |
| Original amounts:                 |                  |                  |
| Capitalized software costs        | \$ 59,069        | \$ 63,260        |
| Customer relationships            | 23,843           | 26,618           |
| Backlog and non-compete agreement | 1,554            | 1,623            |
| Acquired technology               | 3,112            | 4,862            |
|                                   | <u>87,578</u>    | <u>96,363</u>    |
| Accumulated amortization:         |                  |                  |
| Capitalized software costs        | 45,075           | 49,072           |
| Customer relationships            | 8,895            | 12,817           |
| Backlog and non-compete agreement | 630              | 1,142            |
| Acquired technology               | 429              | 789              |
|                                   | <u>55,029</u>    | <u>63,820</u>    |
| Intangible assets, net            | <u>\$ 32,549</u> | <u>\$ 32,543</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:- INTANGIBLE ASSETS (Cont.)

- b. Amortization expenses amounted to \$ 6,687, \$ 7,724 and \$ 7,919 for the years ended December 31, 2012, 2013 and 2014, respectively.
- c. The estimated future amortization expense of intangible assets as of December 31, 2014 is as follows:

|                     |                  |
|---------------------|------------------|
| 2015                | 8,230            |
| 2016                | 7,140            |
| 2017                | 5,764            |
| 2018                | 4,383            |
| 2019                | 3,043            |
| 2020 and thereafter | 3,983            |
|                     | <u>\$ 32,543</u> |

NOTE 9:- GOODWILL

Changes in the carrying amount of goodwill for the years ended December 31, 2013 and 2014 according to the Company's reporting units are as follows (see also 16):

|  | IT<br>professional<br>services | Software<br>services | Total         |
|--|--------------------------------|----------------------|---------------|
| As of January 1, 2013                    | \$ 18,036                      | \$ 26,627            | \$ 44,663     |
| Business combination                     | 9,007                          | 1,036                | 10,043        |
| Classifications                          | 430                            | -                    | 430           |
| Foreign currency translation adjustments | 1,022                          | (845)                | 177           |
| As of December 31, 2013                  | 28,495                         | 26,818               | 55,313        |
| Business combination                     | -                              | 3,664                | 3,664         |
| Classifications                          | -                              | (496)                | (735)         |
| Foreign currency translation adjustments | (1,906)                        | (1,085)              | (2,752)       |
| As of December 31, 2014                  | <u>26,589</u>                  | <u>28,901</u>        | <u>55,490</u> |

The Company performed an annual impairment tests as of December 31, of each of 2012, 2013 and 2014 and did not identify any impairment losses (see Note 2).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 10:- ACCRUED EXPENSES AND OTHER ACCOUNTS PAYABLE

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2013             | 2014             |
| Employees and payroll accruals                           | \$ 6,675         | \$ 7,243         |
| Accrued expenses   | 2,925            | 5,191            |
| Deferred and contingent payments related to acquisitions | 4,167            | 170              |
| Government authorities                                   | 2,495            | 1,395            |
| Other  | 675              | 1,014            |
|  | <u>\$ 16,937</u> | <u>\$ 15,013</u> |

NOTE 11:- LONG TERM DEBT

|  | Interest rate as<br>of December 31,<br>2014 | December 31,    |               |
|--|---|-----------------|---------------|
|  |   | 2013            | 2014          |
|  | %   |                 |               |
| Loans from banks in USD <sup>(1)</sup>                       | 3.7%  | \$ 2,904        | \$ -          |
| Loan from banks and other in NIS                             | 4.1%-5.9%                                   | 405             | 481           |
| Other long term debt   |   | 20              | 8             |
| Less – Current maturities (included under “short-term debt”) |   | (1,055)         | -             |
|  |   | <u>\$ 2,274</u> | <u>\$ 490</u> |

(1) Loan from a US bank, received on November 2013 in the amount of \$3,000, paid monthly in equal payment, for a period of 36 months bearing interest of Libor+3.5%. The loan agreement contains various covenants which require us to maintain certain financial ratios. The Company has met the financial ratios as of December 31, 2013. During 2014 the company repaid the loan.

(2) On November 2013, the Company entered into a credit line agreement with a U.S. bank, under which the bank provides the Company with a credit line of \$3 million for a period of three years. As of December 31, 2014, the Company had drawn down an amount of approximately \$2.8 million from the credit line, which is subject to interest equal to the Prime Rate in effect from time to time, plus 3% per annum; provided that the interest rate in effect on any day shall not be less than 6.0% per annum. In relation to this credit line, the Company is obliged by the bank to comply with certain financial covenants, as defined in the agreement. As of December 31, 2014, the Company was in full compliance with the financial covenants. During January 2015 the company fully repaid the credit line.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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NOTE 12:- TAXES ON INCOME

a. Israeli taxation:

1. Corporate tax rate in Israel:

Taxable income of Israeli companies is subject to tax at the rate of 25% in 2012, 25% in 2013 and 26.5% in 2014.

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

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

In the event of distribution of dividends from the said tax-exempt income, the amount distributed will be subject to corporate tax at the rate ordinarily applicable to the Approved Enterprise's income.

The entitlement to the above benefits is conditional upon the fulfilling of the conditions stipulated by the Laws and regulations. Should they fail to meet such requirements in the future, income attributable to its Approved Enterprise programs could be subject to the statutory Israeli corporate tax rate and they could be required to refund a portion of the tax benefits already received, with respect to such programs. As of December 31, 2014, management believes that the Company's Israeli subsidiaries are in compliance with all the conditions required by the Law.

Effective January 1, 2011, the Knesset enacted the Law for Economic Policy for 2011 and 2012 (Amended Legislation), and among other things, amended the Law, ("the Amendment"). According to the Amendment, the benefit tracks in the Investment Law were modified and a flat tax rate applies to the Company's entire preferred income. The Company will be able to opt to apply (the waiver is non-recourse) the Amendment and from then on it will be subject to the amended tax rates as follows: 2014 - 16%. As of December 31, 2014, the Company has not applied for this amendment. The profits of these "Industrial Companies" will be freely distributable as dividends, subject to a withholding tax of 20% (on distribution commencing January 1, 2014) or lower, under an applicable tax treaty.

The Company and certain of its Israeli subsidiaries intend to apply the new incentives regime under the Amendment to their industrial activity in Israel starting in 2014 and believes it will qualify as an "Beneficiary Company" under the Amendment.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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NOTE 12:- TAXES ON INCOME (Cont.)

3. The Company's Israeli entities have received final tax assessments for their Israeli tax return filings through the year 2010.
4. Tax benefits under the Law for the Encouragement of Industry (Taxes), 1969:

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

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

- b. Non-Israeli subsidiaries:

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

The amount of the Company cash and cash equivalents that are currently held outside of Israel that would be subject to income taxes if distributed as dividends is \$21.2 million. However, a determination of the amount of the unrecognized deferred tax liability for temporary difference related to those undistributed earnings of foreign subsidiaries is not practicable due to the complexity of the structure of our group of subsidiaries for tax purposes and the difficulty of projecting the amount of future tax liability

- c. Net operating loss carryforwards:

As of December 31, 2014, the Company and its Israeli subsidiaries had operating loss carryforwards of \$ 15,929, which can be carried forward and offset against taxable income in the future for an indefinite period.

The Company's subsidiaries in Europe had estimated total available tax loss carryforwards of \$ 4,999 as of December 31, 2014, to offset against future taxable income.

The Company's subsidiaries in the U.S. had estimated total available tax loss carryforwards of \$ 427 as of December 31, 2014, which can be carried forward and offset against taxable income for a period of up to 20 years, from the year the loss was incurred.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 12:- TAXES ON INCOME (Cont.)

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

d. Income before taxes on income:

|          | Year ended December 31, |                  |                  |
|----------|-------------------------|------------------|------------------|
|          | 2012                    | 2013             | 2014             |
| Domestic | \$ 10,462               | \$ 16,165        | \$ 14,690        |
| Foreign  | 6,092                   | 2,266            | 4,183            |
|          | <u>\$ 16,554</u>        | <u>\$ 18,431</u> | <u>\$ 18,873</u> |

e. Taxes on income:

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

|                               | Year ended December 31, |                 |                 |
|-------------------------------|-------------------------|-----------------|-----------------|
|                               | 2012                    | 2013            | 2014            |
| <b>Current:</b>               |                         |                 |                 |
| Domestic                      | \$ (1,291)              | \$ (1,277)      | \$ 241          |
| Foreign                       | 302                     | 781             | 689             |
|                               | <u>(989)</u>            | <u>(496)</u>    | <u>930</u>      |
| <b>Deferred taxes:</b>        |                         |                 |                 |
| Domestic                      | 414                     | 2,673           | 2,575           |
| Foreign                       | 669                     | (602)           | (1,198)         |
|                               | <u>1,083</u>            | <u>2,071</u>    | <u>1,377</u>    |
| Taxes on income (tax benefit) | <u>\$ 94</u>            | <u>\$ 1,575</u> | <u>\$ 2,307</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 12:- TAXES ON INCOME (Cont.)

f. Deferred tax assets and liabilities:

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

|  | <u>December 31,</u> |                 |
|--|---------------------|-----------------|
|  | <u>2013</u>         | <u>2014</u>     |
| Net operating loss carryforwards               | \$ 5,293            | \$ 4,627        |
| Allowances, reserves and intangible assets     | 1,207               | 1,080           |
| Deferred tax assets before valuation allowance | 6,500               | 5,707           |
| Less - valuation allowance                     | (1,154)             | (3,570)         |
| Deferred tax assets                            | 5,346               | 2,137           |
| Capitalized software costs                     | (1,723)             | -               |
| Deferred tax assets, net                       | <u>\$ 3,623</u>     | <u>\$ 2,137</u> |

|                        | <u>December 31,</u> |                 |
|------------------------|---------------------|-----------------|
|                        | <u>2013</u>         | <u>2014</u>     |
| Current tax assets     | \$ 1,949            | \$ 554          |
| Non-current tax assets | 1,674               | 1,583           |
| Deferred tax assets    | <u>\$ 3,623</u>     | <u>\$ 2,137</u> |

Current taxes are included under other accounts receivable and prepaid expenses.

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

|                              | <u>December 31,</u> |                 |
|------------------------------|---------------------|-----------------|
|                              | <u>2013</u>         | <u>2014</u>     |
| Current tax liabilities      | \$ 2,567            | \$ 760          |
| Non-current tax liabilities  | 2,204               | 4,086           |
| Net deferred tax liabilities | <u>\$ 4,771</u>     | <u>\$ 4,846</u> |

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12:- TAXES ON INCOME (Cont.)**

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

Reconciling items between the 2012, 2013 and 2014 statutory tax rate (25%, 25% and 26.5%, respectively) of the Company and the effective tax rate is presented in the following table:

|  | <b>Year ended December 31,</b> |                 |                 |
|--|--------------------------------|-----------------|-----------------|
|  | <b>2012</b>                    | <b>2013</b>     | <b>2014</b>     |
| Income before taxes, as reported in the consolidated statements of income            | \$ 16,554                      | \$ 18,431       | \$ 18,873       |
| Statutory tax rate   | 25%                            | 25%             | 26.5%           |
| Theoretical tax expenses on the above amount at the Israeli statutory tax rate       | \$ 4,139                       | \$ 4,609        | \$ 5,001        |
| Tax adjustment in respect of different tax rates                                     | 444                            | 484             | 80              |
| Deferred taxes on losses for which full valuation allowance was provided in the past | 651                            | (304)           | 236             |
| Changes in valuation allowance   | (2,003)                        | -               | -               |
| Tax benefits in respect of prior years, net  | (1,126)*                       | 203             | (516)           |
| Nondeductible expenses   | 20                             | 95              | 82              |
| Uncertain tax position and other differences   | (2,031)**                      | (3,512)         | (2,576)         |
| <b>Income tax (tax benefit)</b>  | <b>\$ 94</b>                   | <b>\$ 1,575</b> | <b>\$ 2,307</b> |

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

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



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12:- TAXES ON INCOME (Cont.)**

- h. The Company applies ASC 740, "Income Taxes" with regards to tax uncertainties. During the years ended December 31, 2012, 2013 and 2014, the Company recorded \$ 219, \$ 2,811 and \$ 156 of tax income, respectively, as a result of this application.

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

|  |                |
|--|----------------|
| Gross unrecognized tax benefits at January 1, 2012   | \$ 3,528       |
| Increase in tax positions taken in prior years       | 270            |
| Decrease in tax positions taken in prior years       | <u>(489)</u>   |
| Gross unrecognized tax benefits at December 31, 2012 | 3,309          |
| Increase in tax positions taken in prior years       | -              |
| Decrease in tax positions taken in prior years       | <u>(2,811)</u> |
| Gross unrecognized tax benefits at December 31, 2013 | 498            |
| Increase in tax positions taken in prior years       | -              |
| Decrease in tax positions taken in prior years       | <u>(156)</u>   |
| Gross unrecognized tax benefits at December 31, 2014 | <u>\$ 342</u>  |

As of December 31, 2014, the entire amount of unrecognized tax benefit could affect the Company's income tax provision and the effective tax rate.

**NOTE 13:- EQUITY**

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

On December 23, 2010, the Company issued 3,287,616 ordinary shares at a price of \$ 6.5 per share and in a total amount of \$ 20,290 net of issuance expenses. The shares were issued to institutional investors in a private placement. In addition, certain of the purchasers received warrants to purchase up to an aggregate of 1,134,231 ordinary shares at an exercise price of \$ 8.26 per share. The warrants are exercisable as of six months from the date of issuance, have a term of three years, and the exercise price is subject to future adjustment for various events, such as stock splits or dividend distributions. Following the Company's dividend distribution and in respect to warrants issuance agreement. The warrants expired on June 2014.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 13:- EQUITY (Cont.)

c. Stock Option Plans:

Under the Company's 2007 Stock Option Plan, as amended ("the Plan"), options may be granted to employees, officers, directors and consultants of the Company and its subsidiaries. Pursuant to the 2007 Stock Option Plan, the Company reserved for issuance 1,500,000 ordinary shares. In 2012, the Company increased the amount of ordinary shares reserved for issuance by additional 1,000,000 ordinary shares in connection with the 2007 Stock Option Plan (mentioned above). As of December 31, 2014, an aggregate of 1,001,563 ordinary shares of the Company are available for future grants under the Plan. Each option granted under the Plan is exercisable for a period of ten years from the date of the grant of the option. The 2007 Plan will expire on August 1, 2017.

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

A summary of employee option activity under the Plans as of December 31, 2014 and changes during the year ended December 31, 2014 are as follows:

|  | Number<br>of options | Weighted<br>average<br>exercise<br>price | Weighted<br>average<br>remaining<br>contractual<br>term<br>(in years) | Aggregate<br>intrinsic<br>value |
|--|----------------------|--|---|---------------------------------|
| Outstanding at January 1, 2014                   | 703,110              | \$ 3.16                                  | 6.68  | \$ 2,298                        |
| Granted  | 155,000              | \$ 7.47                                  |   |                                 |
| Exercised  | (115,721)            | \$ 1.86                                  |   |                                 |
| Forfeited  | (3,500)              | \$ 4.00                                  |   |                                 |
| Outstanding at December 31, 2014                 | <u>738,889</u>       | <u>\$ 4.26</u>                           | <u>6.42</u>   | <u>\$ 1,248</u>                 |
| Exercisable at December 31, 2014                 | <u>448,639</u>       | <u>\$ 2.95</u>                           | <u>5.03</u>   | <u>\$ 1,348</u>                 |
| Vested and expected to vest at December 31, 2014 | <u>738,889</u>       | <u>\$ 4.26</u>                           | <u>6.42</u>   | <u>\$ 1,248</u>                 |

The weighted-average grant-date fair value of options granted during the years ended December 31, 2012, 2013 and 2014 was \$4, \$ 6 and \$ 3.76, 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, 2014. This amount is changed based on the market value of the Company's ordinary shares. Total intrinsic value of options exercised during the years ended December 31, 2012, 2013 and 2014 was \$ 572, \$ 529 and \$ 741, respectively. As of December 31, 2014, there was \$ 646 of unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Plans. This cost is expected to be recognized over a period of approximately three years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 13:- EQUITY (Cont.)

The options outstanding as of December 31, 2014, have been separated into ranges of exercise price categories, as follows:

| Exercise price | Options outstanding | Weighted average contractual life (years) | Weighted average exercise price | Options exercisable | Weighted average exercise price of exercisable options |
|----------------|---------------------|---|---------------------------------|---------------------|--|
| In \$          |                     |   |                                 |                     |  |
| 0-1            | 4,000               | 4.24                                      | \$ -                            | 4,000               | \$ -   |
| 1.01-2         | 69,200              | 1.85                                      | \$ 1.20                         | 69,200              | \$ 1.20  |
| 2.01-3         | 173,667             | 4.80                                      | \$ 2.30                         | 173,667             | \$ 2.30  |
| 3.01-4         | 252,022             | 6.12                                      | \$ 3.96                         | 180,522             | \$ 3.95  |
| 4.01-5         | -                   | -   | \$ -                            | -                   | \$ -   |
| 5.01-6         | 85,000              | 8.61                                      | \$ 6.00                         | 21,250              | \$ 6.00  |
| 6.01-7         | 75,000              | 9.87                                      | \$ 6.89                         | -                   | \$ -   |
| 7.01-8         | -                   | -   | \$ -                            | -                   | \$ -   |
| 8.01-9         | 80,000              | 9.36                                      | \$ 8.01                         | -                   | \$ -   |
|                | <u>738,889</u>      | <u>6.42</u>                               | <u>\$ 4.26</u>                  | <u>448,639</u>      | <u>\$ 2.95</u>   |

d. Accumulated other comprehensive income:

|  | December 31,    |                 |                   |
|--|-----------------|-----------------|-------------------|
|  | 2012            | 2013            | 2014              |
| Accumulated realized and unrealized gain on available-for-sale securities, net | \$ 173          | \$ 138          | \$ (121)          |
| Accumulated foreign currency translation adjustments                           | (776)           | (327)           | (5,243)           |
| Accumulated unrealized gain (loss) on derivative instruments, net              | 17              | 17              | 17                |
| Total other comprehensive income   | <u>\$ (586)</u> | <u>\$ (172)</u> | <u>\$ (5,347)</u> |

e. On September 4, 2012, the Company's Board of Directors adopted a dividend distribution policy, subject to any applicable law. According to this policy, each year the Company will distribute a dividend of up to 50% of its annual distributable profits. It is possible that the Board of Directors will decide, subject to the conditions stated above, to declare additional dividend distributions. The Company's Board of Directors may at its discretion and at any time, change, whether as a result of a one-time decision or a change in policy, the rate of dividend distributions and/or not to distribute a dividend, all at its discretion.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- EQUITY (Cont.)**

In respect to the policy mentioned above, on September 10, 2012 and on February 14, 2013, the Company declared a dividend distribution of \$ 0.10 per share (\$ 3,661 in the aggregate) and \$ 0.12 per share (\$ 4,397 in the aggregate) which were paid on October 17, 2012 and on March 14, 2013, respectively. On August 12, 2013 the Company declared a dividend distribution of \$ 0.09 per share (\$ 3,390 in the aggregate) which was paid on September 3, 2013. On February 18, 2014, the Company declared a dividend distribution of \$ 0.12 per share (\$ 4,468 in the aggregate) which was paid on March 14, 2014. On August 19, 2014 the Company declared a dividend distribution of \$ 0.095 per share (\$ 4,195 in the aggregate) which was paid on September 4, 2014. On February 4, 2015, the Company declared a dividend distribution of \$ 0.081 per share (see also note 18).

- f. On November 2014, a Company's subsidiary granted one of its executive options exercisable for 1,167 ordinary shares in its subsidiary. The options are vested in equal quarterly installments, over a four year period that commences in January 1, 2013 and concludes in March 31, 2016, if meeting a certain operational margin during 2013, 2014 and 2015. The exercise price of the options is NIS 1 per share. Total fair value of the grant was calculated based on the Company subsidiary's fair value on the grant date and totaled NIS 5,910 thousand (NIS 5 thousand per share).

**NOTE 14:- SELECTED STATEMENTS OF INCOME DATA**

- a. Research and development costs, net:

|                                   | <b>Year ended December 31,</b> |             |             |
|-----------------------------------|--------------------------------|-------------|-------------|
|                                   | <b>2012</b>                    | <b>2013</b> | <b>2014</b> |
| Total costs                       | \$ 7,916                       | \$ 8,419    | \$ 9,017    |
| Less - capitalized software costs | (4,969)                        | (4,713)     | (4,267)     |
| Research and development, net     | \$ 2,947                       | \$ 3,706    | \$ 4,750    |

- b. Financial income (expenses), net:

|  |       |          |            |
|--|-------|----------|------------|
| Interest income net of bank charges                                      | \$ 20 | \$ (170) | \$ (156)   |
| Interest expenses related to liabilities in connection with acquisitions | (48)  | (407)    | (152)      |
| Interest income from debt instruments                                    | 49    | 46       | 91         |
| Loss arising from foreign currency translation and other                 | (11)  | (153)    | (1,569)    |
| Financial income(expenses), net  | \$ 10 | \$ (684) | \$ (1,786) |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 15:- COMMITMENTS AND CONTINGENCIES

a. Lease commitments:

Certain of the motor vehicles, facilities and equipment of the Company and its subsidiaries are rented under long-term operating lease agreements. Future minimum lease commitments under non-cancelable operating leases as of December 31, 2014, are as follows:

|                     |                 |
|---------------------|-----------------|
| 2015                | \$ 1,798        |
| 2016                | 773             |
| 2017                | 578             |
| 2018 and thereafter | 583             |
|                     | <u>\$ 3,732</u> |

Rent expenses for the years ended December 31, 2012, 2013 and 2014 were approximately \$ 1,701, \$ 1,911 and \$ 1,736, respectively.

The Company leases motor vehicles under a cancelable lease agreement. The Company has an option to be released from this lease agreement, which may result in penalties in a maximum amount of \$ 147.

The Company currently occupies approximately 59,546 square feet of space based on a lease agreement expiring in December, 2014. The Company has an option to terminate the lease agreement in Israel and India upon six months prior written notice.

The aggregated amount of lease commitment for the next 6 months in Israel and India mentioned above is approximately \$ 259.

b. Guarantees and Collaterals:

The Company and certain of its subsidiaries have provided three of their clients with performance bank guarantees totaling \$ 295, which are linked to the New Israeli Shekels, all of which will be terminated during 2015 and 2016.

Several of the Company's subsidiaries have pledged their accounts receivables to a financial institution, with respect to a US dollar loan received in 2013 (see also note 11).

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 15:- COMMITMENTS AND CONTINGENCIES (Cont.)**

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

1. In August 2009, a software company and one of its owners filed an arbitration proceeding against the company and one of its subsidiaries, claiming an alleged breach of a non-disclosure agreement between the parties. The plaintiffs sought damages in the amount of approximately NIS 52 million (approximately \$15 million). The arbitrator determined that both the company and its subsidiary breached the non-disclosure agreement. In January 2015 the arbitrator rendered his ruling and determined that the company should pay damages to the plaintiffs. The company financial results of operations include a net impact of \$1.6 million resulting from the arbitration. The company is considering its options following this ruling.
2. In addition to the above mentioned legal proceedings, the Company is also involved in various legal proceedings arising in the normal course of its business. Based upon the advice of counsel, the Company does not believe that the ultimate resolution of these matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**NOTE 16:- NET EARNINGS PER SHARE**

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

|   | <b>Year ended December 31,</b> |                   |                   |
|---|--------------------------------|-------------------|-------------------|
|   | <b>2012</b>                    | <b>2013</b>       | <b>2014</b>       |
| Numerator for basic and diluted earnings per share - net income available to Magic shareholders | <u>\$ 16,183</u>               | <u>\$ 15,880</u>  | <u>\$ 15,403</u>  |
| Weighted average ordinary shares outstanding:   |                                |                   |                   |
| Denominator for basic net earnings per share  | 36,502,264                     | 36,835,163        | 43,287,523        |
| Effect of dilutive securities   | <u>605,406</u>                 | <u>458,753</u>    | <u>17,291</u>     |
| Denominator for diluted net earnings per share  | <u>37,107,670</u>              | <u>37,293,916</u> | <u>43,304,814</u> |
| Basic and diluted earnings per share  | <u>\$ 0.44</u>                 | <u>\$ 0.43</u>    | <u>\$ 0.36</u>    |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 17:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS

- a. The Company reports its results on the basis of two reportable business segments: software services (which include proprietary and non proprietary software technology) and IT professional services.

The Company evaluates segment performance based on revenues and operating income of each segment. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. This data is presented in accordance with ASC 280, "Segment Reporting."

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

**Software services**

The Company develops markets, sells and supports a proprietary and non proprietary application platform, software applications, business and process integration solutions and related services.

**IT professional services**

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

There are no significant transactions between the two segments.

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

|                                 | Software<br>services | IT<br>professional<br>services | Unallocated<br>expense | Total      |
|---------------------------------|----------------------|--------------------------------|------------------------|------------|
| <b>2012</b>                     |                      |                                |                        |            |
| Total revenues                  | \$ 65,410            | \$ 60,970                      | \$ -                   | \$ 126,380 |
| Expenses                        | 50,497               | 55,456                         | 4,019                  | 109,972    |
| Segment operating income (loss) | \$ 14,913            | \$ 5,514                       | \$ (4,019)             | \$ 16,408  |
| Depreciation and amortization   | \$ 5,937             | \$ 1,182                       | \$ 344                 | \$ 7,463   |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 17:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS (Cont.)

|                                 | Software services | IT professional services | Unallocated expense | Total      |
|---------------------------------|-------------------|--------------------------|---------------------|------------|
| <b>2013</b>                     |                   |                          |                     |            |
| Total revenues                  | \$ 67,453         | \$ 77,505                | \$ -                | \$ 144,958 |
| Expenses                        | 53,164            | 68,846                   | 3,821               | 125,831    |
| Segment operating income (loss) | \$ 14,289         | \$ 8,659                 | \$ (3,821)          | \$ 19,127  |
| Depreciation and amortization   | \$ 5,917          | \$ 2,210                 | \$ 253              | \$ 8,380   |
| <b>2014</b>                     |                   |                          |                     |            |
| Total revenues                  | \$ 69,861         | \$ 94,443                | \$ -                | \$ 164,304 |
| Expenses                        | 54,464            | 84,873                   | 4,241               | 143,578    |
| Segment operating income (loss) | \$ 15,397         | \$ 9,570                 | \$ (4,241)          | \$ 20,726  |
| Depreciation and amortization   | \$ 6,065          | \$ 2,263                 | \$ 266              | \$ 8,594   |

- c. The Company's business is divided into the following geographic areas: Israel, Europe, the United States, Japan and other regions. Total revenues are attributed to geographic areas based on the location of the customers.

The following table presents total revenues classified according to geographical destination for the years ended December 31, 2012, 2013 and 2014:

|               | Year ended December 31, |            |            |
|---------------|-------------------------|------------|------------|
|               | 2012                    | 2013       | 2014       |
| Israel        | \$ 11,561               | \$ 24,006  | \$ 29,198  |
| Europe        | 29,139                  | 31,386     | 37,409     |
| United States | 64,591                  | 70,872     | 78,606     |
| Japan         | 12,661                  | 11,965     | 11,299     |
| Other         | 8,428                   | 6,729      | 3,927      |
|               | \$ 126,380              | \$ 144,958 | \$ 164,304 |



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 17:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS (Cont.)**

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

|               | <b>December 31,</b> |                  |
|---------------|---------------------|------------------|
|               | <b>2013</b>         | <b>2014</b>      |
| Israel        | \$ 54,656           | \$ 58,263        |
| Europe        | 3,117               | 1,523            |
| United States | 23,287              | 22,174           |
| Japan         | 5,180               | 4,786            |
| Other         | 3,395               | 3,291            |
|               | <u>\$ 89,634</u>    | <u>\$ 90,039</u> |

- e. The Company does not allocate its assets to its reportable segments; accordingly, asset information by reportable segments is not presented.
- f. In 2012, 2013 and 2014, the Company had one customer, included in the IT professional services segment, which accounted for 19%, 13% and 10% of the group revenues, respectively.

**NOTE 18:- SUBSEQUENT EVENTS**

- a. On February 25, 2015 the Company entered into a definitive agreement to acquire a 70% stake, with an option to increase the holding to 100%, in an Israeli-based company specializes in software professional services for mainframes and complex large-scale environments. The acquisition is subject to the fulfillment of certain conditions defined in the acquisition agreement.
- b. On February 4, 2015, the Company declared a dividend distribution of \$ 0.081 per share (\$ 3,582 in the aggregate) which will be paid on March 11, 2015. The dividend distribution relates to the Company's earnings in the second half of 2014.

APPENDIX TO CONSOLIDATED FINANCIAL STATEMENTS

DETAILS OF SUBSIDIARIES AND AFFILIATE

Details of the percentage of control of the share capital and voting rights of subsidiaries and an affiliate as of December 31, 2014:

| Name of Company   | Percentage of ownership<br>and control<br>% | Place of incorporation |
|---|---|------------------------|
| Magic Software Japan K.K.   | 100   | Japan                  |
| Magic Software Enterprises Inc.   | 100   | U.S.A.                 |
| Magic Software Enterprises (UK) Ltd.                                      | 100   | U.K.                   |
| Hermes Logistics Technologies Limited.                                    | 100   | U.K.                   |
| Magic Software Enterprises Spain Ltd.                                     | 100   | Spain                  |
| Coretech Consulting Group Inc.  | 100   | U.S.A                  |
| Coretech Consulting Group LLC.  | 100   | U.S.A                  |
| Fusion Solutions LLC.   | 100   | U.S.A                  |
| Xsell Resources Inc.  | 100   | U.S.A                  |
| Magic Software Enterprises (Israel) Ltd.                                  | 100   | Israel                 |
| Magic Software Enterprises Netherlands B.V.                               | 100   | Netherlands            |
| Magic Software Enterprises France   | 100   | France                 |
| Magic Beheer B.V.   | 100   | Netherlands            |
| Magic Benelux B.V.  | 100   | Netherlands            |
| Magic Software Enterprises GMBH   | 100   | Germany                |
| Magic Software Enterprises India Pvt. Ltd.                                | 100   | India                  |
| Onyx Magyarorszag Szsoftverhaz .  | 100   | Hungary                |
| Magix Integration (Proprietary) Ltd                                       | 100   | South Africa           |
| Appbuilder Solutions Ltd  | 100   | U.K.                   |
| Complete Business Solutions Ltd   | 96.3  | Israel                 |
| Comm-IT Technology Solutions Ltd  | 80  | Israel                 |
| Comm-IT Software Ltd  | 100   | Israel                 |
| Comm-IT Embedded Ltd (shares held by<br>Comm-IT Technology Solutions Ltd. | 50.1  | Israel                 |
| Pilat (North America), Inc  | 100   | U.S.A                  |
| Pilat Europe Ltd  | 100   | U.K.                   |
| Valinor Ltd   | 100   | Israel                 |
| Dario Solutions IT Ltd  | 100   | Israel                 |
| BridgeQuest Labs, Inc   | 100   | U.S.A                  |
| BridgeQuest, Inc  | 100   | U.S.A                  |
| Allstates Consulting Services LLC   | 100   | U.S.A                  |
| Formula Telecom Solutions, Ltd  | 100   | Israel                 |
| FTS Bulgaria (FTS Global Ltd.)  | 100   | Bulgaria               |
| DataMind Technologies Ltd   | 80  | Israel                 |

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

**Magic Software Enterprises (UK) Limited**

We have audited the accompanying balance sheet of Magic Software Enterprises (UK) Limited (the "Company") as of December 31, 2014 and 2013, and the related profit and loss account and changes in shareholders' equity for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2013 and 2012, and the related profit and loss account and changes in shareholders' equity for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

Yours sincerely,  
LEVY COHEN & CO.



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Registered Auditors and Certified  
Public Accountants

January 29, 2015

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

**Hermes Logistics Technologies Limited**

We have audited the accompanying balance sheet of Hermes Logistics Technologies Limited (the "Company") as of December 31, 2014 and 2013, and the related profit and loss account and changes in shareholders' equity for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2014 and 2013, and the related profit and loss account and changes in shareholders' equity for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

Yours sincerely,  
LEVY COHEN & CO.



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Registered Auditors and Certified  
Public Accountants

March 13, 2015

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of  
Magic Software Japan K. K.**

We have audited the accompanying balance sheets of Magic Software Japan K.K. (the "Company") as of December 31, 2013 and 2014, and the related statements of operations and cash flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2014, and the related statements of operations and cash flows for each of the three years in the period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America.

Tokyo, Japan  
January 28, 2015



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KDA Audit Corporation

SAPIENS INTERNATIONAL CORPORATION N.V.  
CONSOLIDATED FINANCIAL STATEMENTS  
AS OF DECEMBER 31, 2014  
IN U.S. DOLLARS  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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

**SAPIENS INTERNATIONAL CORPORATION N.V.**

We have audited the accompanying consolidated balance sheets of Sapiens International Corporation N.V. ("the Company") as of December 31, 2013 and 2014, and the related consolidated statements of income, statements of comprehensive income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2013 and 2014 and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2014, 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, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated March 29, 2015, expressed an unqualified opinion thereon.

Tel-Aviv, Israel  
March 29, 2015

**KOST FORER GABBAY & KASIERER**  
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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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

**SAPIENS INTERNATIONAL CORPORATION N.V.**

We have audited Sapiens International Corporation N.V. ("the Company") internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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



In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, 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 Sapiens International Corporation N.V. as of December 31, 2013 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2014 and our report dated March 29, 2015 expressed an unqualified opinion thereon.

Tel-Aviv, Israel  
March 29, 2015

KOST FORER GABBAY & KASIERER  
A Member of EY Global

**CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands

|   | December 31,      |                   |
|---|-------------------|-------------------|
|   | 2013              | 2014              |
| <b>ASSETS</b>   |                   |                   |
| <b>CURRENT ASSETS:</b>  |                   |                   |
| Cash and cash equivalents   | \$ 70,313         | \$ 47,400         |
| Trade receivables (net of allowance for doubtful accounts of \$ 293 and \$ 215 at December 31, 2013 and 2014, respectively) | 23,669            | 28,540            |
| Other receivables and prepaid expenses  | 4,126             | 3,962             |
| Deferred tax assets   | 2,420             | 2,319             |
| <b>Total current assets</b>   | <b>100,528</b>    | <b>82,221</b>     |
| <b>LONG-TERM ASSETS:</b>  |                   |                   |
| Marketable securities   | -                 | 33,098            |
| Other long-term assets  | 2,957             | 3,248             |
| Severance pay fund  | 11,228            | 10,735            |
| Capitalized software development costs, net   | 19,704            | 18,680            |
| Other intangible assets, net  | 10,310            | 8,380             |
| Goodwill  | 72,438            | 67,698            |
| Property and equipment, net   | 5,263             | 4,763             |
| <b>Total long-term assets</b>   | <b>121,900</b>    | <b>146,602</b>    |
| <b>Total assets</b>   | <b>\$ 222,428</b> | <b>\$ 228,823</b> |

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

**CONSOLIDATED BALANCE SHEETS**

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

|  | December 31,      |                   |
|--|-------------------|-------------------|
|  | 2013              | 2014              |
| <b>LIABILITIES AND EQUITY</b>  |                   |                   |
| <b>CURRENT LIABILITIES:</b>  |                   |                   |
| Trade payables   | \$ 6,517          | \$ 2,952          |
| Employees and payroll accruals   | 13,577            | 14,619            |
| Accrued expenses and other liabilities   | 6,990             | 10,540            |
| Deferred revenues and customer advances  | 9,928             | 9,272             |
| <b>Total current liabilities</b>   | <b>37,012</b>     | <b>37,383</b>     |
| <b>LONG-TERM LIABILITIES:</b>  |                   |                   |
| Other long-term liabilities  | 2,393             | 3,105             |
| Accrued severance pay  | 12,615            | 11,980            |
| <b>Total long-term liabilities</b>   | <b>15,008</b>     | <b>15,085</b>     |
| <b>COMMITMENTS AND CONTINGENT LIABILITIES</b>  |                   |                   |
| <b>REDEEMABLE NON-CONTROLLING INTEREST</b>   | <b>-</b>          | <b>159</b>        |
| <b>EQUITY:</b>   |                   |                   |
| Sapiens International Corporation N.V. Shareholders' equity:                                   |                   |                   |
| Share capital:   |                   |                   |
| Common shares of € 0.01 par value:   |                   |                   |
| Authorized: 54,000,000 shares at December 31, 2013 and 2014;                                   |                   |                   |
| Issued: 48,343,278 and 50,007,607 shares at December 31, 2013 and 2014, respectively;          |                   |                   |
| Outstanding: 46,014,982 and 47,679,311 shares at December 31, 2013 and 2014, respectively      |                   |                   |
|  | 645               | 667               |
| Additional paid-in capital   | 244,560           | 247,174           |
| Treasury shares, at cost - 2,328,296 Common shares at December 31, 2013 and 2014, respectively | (9,423)           | (9,423)           |
| Accumulated other comprehensive income (loss)  | 1,082             | (10,281)          |
| Accumulated deficit  | (67,093)          | (52,630)          |
| <b>Total Sapiens International Corporation N.V. shareholders' equity</b>                       | <b>169,771</b>    | <b>175,507</b>    |
| Non-controlling interests  | 637               | 689               |
| <b>Total equity</b>  | <b>170,408</b>    | <b>176,196</b>    |
| <b>Total liabilities and equity</b>  | <b>\$ 222,428</b> | <b>\$ 228,823</b> |

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

**CONSOLIDATED STATEMENTS OF INCOME**

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

|   | Year ended December 31, |                  |                  |
|---|-------------------------|------------------|------------------|
|   | 2012                    | 2013             | 2014             |
| <b>Revenues:</b>  |                         |                  |                  |
| License   | \$ 10,025               | \$ 15,164        | \$ 13,204        |
| Services  | 103,884                 | 120,213          | 144,246          |
| <b>Total Revenues</b>   | <b>113,909</b>          | <b>135,377</b>   | <b>157,450</b>   |
| <b>Cost of revenues:</b>  |                         |                  |                  |
| License   | 624                     | 953              | 883              |
| Services  | 65,835                  | 84,018           | 98,212           |
| <b>Total cost of revenues</b>                                       | <b>66,459</b>           | <b>84,971</b>    | <b>99,095</b>    |
| <b>Gross profit</b>   | <b>47,450</b>           | <b>50,406</b>    | <b>58,355</b>    |
| <b>Operating expenses:</b>  |                         |                  |                  |
| Research and development  | 10,169                  | 11,846           | 11,352           |
| Selling, marketing, general and administrative                      | 25,236                  | 26,677           | 32,097           |
| <b>Total operating expenses</b>                                     | <b>35,405</b>           | <b>38,523</b>    | <b>43,449</b>    |
| <b>Operating income</b>   | <b>12,045</b>           | <b>11,883</b>    | <b>14,906</b>    |
| Financial income, net   | 193                     | 520              | 124              |
| <b>Income before taxes on income</b>                                | <b>12,238</b>           | <b>12,403</b>    | <b>15,030</b>    |
| Taxes on income   | (435)                   | (811)            | (454)            |
| <b>Net income</b>   | <b>11,803</b>           | <b>11,592</b>    | <b>14,576</b>    |
| Attributed to redeemable non-controlling interest                   | -                       | -                | (18)             |
| Attributable to non-controlling interests                           | 23                      | (12)             | 131              |
| <b>Net income attributable to Sapiens' shareholders</b>             | <b>\$ 11,780</b>        | <b>\$ 11,604</b> | <b>\$ 14,463</b> |
| <b>Net earnings per share attributable to Sapiens' shareholders</b> |                         |                  |                  |
| Basic   | \$ 0.29                 | \$ 0.29          | \$ 0.31          |
| Diluted   | \$ 0.28                 | \$ 0.27          | \$ 0.30          |

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

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

U.S. dollars in thousands

|  | Year ended December 31, |                  |                 |
|--|-------------------------|------------------|-----------------|
|  | 2012                    | 2013             | 2014            |
| Net income   | \$ 11,803               | \$ 11,592        | \$ 14,576       |
| <b>Other comprehensive income:</b>   |                         |                  |                 |
| Foreign currency translation adjustments   | 1,441                   | 5,923            | (11,181)        |
| Unrealized losses arising from marketable securities during the period, net of tax benefit of \$57 | -                       | -                | (158)           |
| Gains reclassified into earnings from marketable securities, net of tax expense of \$1             | -                       | -                | 3               |
|  | <u>1,441</u>            | <u>5,923</u>     | <u>(11,336)</u> |
| Total comprehensive income   | <u>13,244</u>           | <u>17,515</u>    | <u>3,240</u>    |
| Comprehensive income attributed to redeemable non-controlling interest                             | -                       | -                | (18)            |
| Comprehensive income attributable to non-controlling interests                                     | <u>57</u>               | <u>(41)</u>      | <u>158</u>      |
| Comprehensive income attributable to Sapiens' shareholders   | <u>\$ 13,187</u>        | <u>\$ 17,556</u> | <u>\$ 3,100</u> |

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

**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**

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

|  | Common stock |        | Additional paid-in capital | Treasury shares | Accumulated Other Comprehensive Income (loss) | Accumulated deficit | Non-controlling interests | Total equity |
|--|--------------|--------|----------------------------|-----------------|---|---------------------|---------------------------|--------------|
|  | Shares       | Amount |                            |                 |   |                     |                           |              |
| Balance as of January 1, 2012                                | 39,680,630   | \$ 534 | \$ 207,930                 | \$ (2,423)      | \$ (6,277)                                    | \$ (90,477)         | \$ 960                    | \$ 110,247   |
| Stock-based compensation                                     | -            | -      | 690                        | -               | -   | -                   | -                         | 690          |
| Stock-based compensation with respect to Harcase acquisition | -            | -      | 241                        | -               | -   | -                   | -                         | 241          |
| Repurchase of shares   | (2,000,000)  | -      | -                          | (7,000)         | -   | -                   | -                         | (7,000)      |
| Employee stock options exercised (cash and cashless)         | 998,875      | 13     | 1,186                      | -               | -   | -                   | -                         | 1,199        |
| Dividend to non-controlling interests                        | -            | -      | -                          | -               | -   | -                   | (182)                     | (182)        |
| Other comprehensive income                                   | -            | -      | -                          | -               | 1,407   | -                   | 34                        | 1,441        |
| Net income   | -            | -      | -                          | -               | -   | 11,780              | 23                        | 11,803       |
| Balance as of December 31, 2012                              | 38,679,505   | 547    | 210,047                    | (9,423)         | (4,870)                                       | (78,697)            | 835                       | 118,439      |
| Stock-based compensation                                     | -            | -      | 933                        | -               | -   | -                   | -                         | 933          |
| Issuance of shares upon public offering, net                 | 6,497,400    | 87     | 37,704                     | -               | -   | -                   | -                         | 37,791       |
| Distribution of dividend                                     | -            | -      | (5,802)                    | -               | -   | -                   | -                         | (5,802)      |
| Employee stock options exercised (cash and cashless)         | 815,564      | 11     | 1,678                      | -               | -   | -                   | -                         | 1,689        |
| Warrants exercised (cashless)                                | 22,513       | -      | -                          | -               | -   | -                   | -                         | -            |
| Dividend to non-controlling interests                        | -            | -      | -                          | -               | -   | -                   | (157)                     | (157)        |
| Other comprehensive income (loss)                            | -            | -      | -                          | -               | 5,952   | -                   | (29)                      | 5,923        |
| Net income   | -            | -      | -                          | -               | -   | 11,604              | (12)                      | 11,592       |
| Balance as of December 31, 2013                              | 46,014,982   | 645    | 244,560                    | (9,423)         | 1,082   | (67,093)            | 637                       | 170,408      |
| Stock-based compensation                                     | -            | -      | 1,067                      | -               | -   | -                   | -                         | 1,067        |
| Employee stock options exercised (cash and cashless)         | 1,225,368    | 17     | 1,552                      | -               | -   | -                   | -                         | 1,569        |
| Warrants exercised (cashless)                                | 438,961      | 5      | (5)                        | -               | -   | -                   | -                         | -            |
| Dividend to non-controlling interests                        | -            | -      | -                          | -               | -   | -                   | (106)                     | (106)        |
| Other comprehensive income (loss)                            | -            | -      | -                          | -               | (11,363)                                      | -                   | 27                        | (11,336)     |
| Net income   | -            | -      | -                          | -               | -   | 14,463              | 131                       | 14,594       |
| Balance as of December 31, 2014                              | 47,679,311   | \$ 667 | \$ 247,174                 | \$ (9,423)      | \$ (10,281)                                   | \$ (52,630)         | \$ 689                    | \$ 176,196   |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

|  | Year ended December 31, |                   |                    |
|--|-------------------------|-------------------|--------------------|
|  | 2012                    | 2013              | 2014               |
| <b>Cash flows from operating activities:</b>                               |                         |                   |                    |
| Net income   | \$ 11,803               | \$ 11,592         | \$ 14,576          |
| Reconciliation of net income to net cash provided by operating activities: |                         |                   |                    |
| Depreciation and amortization  | 7,393                   | 7,887             | 8,717              |
| Stock-based compensation   | 690                     | 933               | 1,067              |
| Compensation associated with acquisition of subsidiary                     | 128                     | -                 | -                  |
| Amortization of premium and accrued interest on marketable securities      | -                       | -                 | (225)              |
| Net changes in operating assets and liabilities, net of amount acquired:   |                         |                   |                    |
| Trade receivables, net   | (1,649)                 | (6,677)           | (6,637)            |
| Other operating assets   | 152                     | (2,317)           | 127                |
| Deferred tax assets, net   | (194)                   | 1,133             | (1,020)            |
| Trade payables   | 1,746                   | 1,874             | (3,297)            |
| Other operating liabilities  | 333                     | 383               | 8,469              |
| Deferred revenues and customer advances                                    | (2,372)                 | 2,508             | (223)              |
| Accrued severance pay, net   | 762                     | (50)              | 7                  |
| Net cash provided by operating activities                                  | <u>18,792</u>           | <u>17,266</u>     | <u>21,561</u>      |
| <b>Cash flows from investing activities:</b>                               |                         |                   |                    |
| Purchase of property and equipment   | (1,327)                 | (4,129)           | (1,468)            |
| Capitalized software development costs                                     | (3,464)                 | (5,392)           | (6,094)            |
| Acquisition of KPI (b)   | -                       | -                 | (2,064)            |
| Investment in marketable securities  | -                       | -                 | (34,906)           |
| Proceeds from sale of marketable securities                                | -                       | -                 | 1,543              |
| Restricted cash  | (68)                    | (210)             | 239                |
| Net cash used in investing activities                                      | <u>\$ (4,859)</u>       | <u>\$ (9,731)</u> | <u>\$ (42,750)</u> |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**U.S. dollars in thousands**

|   | Year ended December 31, |                  |                   |
|---|-------------------------|------------------|-------------------|
|   | 2012                    | 2013             | 2014              |
| <b>Cash flows from financing activities:</b>                                      |                         |                  |                   |
| Proceeds from employee stock options exercised                                    | \$ 1,199                | \$ 1,689         | \$ 1,569          |
| Repurchase of shares  | (7,000)                 | -                | -                 |
| Issuance of shares upon public offering, net                                      | -                       | 37,791           | -                 |
| Distribution of dividend  | -                       | (5,802)          | -                 |
| Dividend to non-controlling interest  | (182)                   | (157)            | (106)             |
| Net cash provided by (used in) financing activities                               | <u>(5,983)</u>          | <u>33,521</u>    | <u>1,463</u>      |
| Effect of exchange rate changes on cash   | <u>(360)</u>            | <u>207</u>       | <u>(3,187)</u>    |
| Increase (decrease) in cash and cash equivalents                                  | 7,590                   | 41,263           | (22,913)          |
| Cash and cash equivalents at beginning of year                                    | <u>21,460</u>           | <u>29,050</u>    | <u>70,313</u>     |
| Cash and cash equivalents at end of year  | <u>\$ 29,050</u>        | <u>\$ 70,313</u> | <u>\$ 47,400</u>  |
| <b>Supplemental cash flow activities:</b>   |                         |                  |                   |
| <b>(a) Cash paid (received) during the year for:</b>                              |                         |                  |                   |
| Interest paid   | <u>\$ 2</u>             | <u>\$ 7</u>      | <u>\$ 5</u>       |
| Interest received   | <u>\$ 5</u>             | <u>\$ 7</u>      | <u>\$ (604)</u>   |
| Income taxes  | <u>\$ 1,752</u>         | <u>\$ 739</u>    | <u>\$ 665</u>     |
| <b>(b) Acquisition of KPI</b>   |                         |                  |                   |
| Fair value of assets acquired and liabilities assumed at the date of acquisition: |                         |                  |                   |
| Working capital, net (excluding cash and cash equivalents)                        | \$ -                    | \$ -             | \$ (228)          |
| Goodwill and other intangible assets  | -                       | -                | (2,013)           |
| Redeemable non-controlling interest   | -                       | -                | 177               |
|   | <u>\$ -</u>             | <u>\$ -</u>      | <u>\$ (2,064)</u> |

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



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1: GENERAL**

## a. General:

Sapiens International Corporation N.V. (“Sapiens”) and its subsidiaries (collectively, the “Company”), a member of the Formula Systems (1985) Ltd. Group, is a global provider of software solutions for the insurance industry, with an emerging focus on the broader financial services sector. The Company's offerings include a broad range of software solutions and services, comprised of (i) core software solutions for the insurance industry, including Property & Casualty/General Insurance (“P&C”) and Life, Annuities and Pensions (“L&P”) products, and record keeping software solutions for providers of Retirement Services (ii) variety of technology based solution including business decision management solutions for the financial services industry, including insurance, banking and capital markets and (iii) global Services including project delivery and implementation of the Company’ software solutions.

The Company's target markets are primarily North America, United Kingdom, Israel, Europe, and Asia Pacific.

## b. Acquisition of KPI:

On August 1, 2014, the Company completed the acquisition of all of the outstanding shares of Knowledge Partners International (KPI), a pioneer and recognized leader in decision management consultancy, services and training, in consideration of \$ 2,380, composed of the following:

|                       |    |              |
|-----------------------|----|--------------|
| Cash Payment          | \$ | 2,203        |
| Share consideration * |    | 177          |
| Total purchase price  | \$ | <u>2,380</u> |

\*) Sapiens issued 57,000 shares of its subsidiary, Sapiens software solution (Decision) LTD, reflecting 3% of the subsidiary's outstanding shares. According to the agreement the sellers will have the right to sell their minority interests to the Company during the period commencing on the date that is 48 months following the acquisition date, and the Company will have corresponding call option.

Sapiens issued additional 88,500 restricted shares of its subsidiary, Sapiens software solution (Decision) Ltd, vesting and expensed over a period of 3 years commencing the acquisition date.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1: GENERAL (Cont.)**

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

|  |    |              |
|--|----|--------------|
| Cash and cash equivalents              | \$ | 139          |
| Trade receivables                      |    | 313          |
| Other receivables and prepaid expenses |    | 89           |
| Property and equipment                 |    | 4            |
| Patent                                 |    | 1,400        |
| Goodwill                               |    | 613          |
|  |    | <u>2,558</u> |
| Total assets acquired                  |    | 2,558        |
| Trade payables                         |    | (87)         |
| Accrued expenses and other liabilities |    | (91)         |
|  |    | <u>(178)</u> |
| Total liabilities assumed              |    | (178)        |
| Total assets acquired, net             | \$ | <u>2,380</u> |

Pro-forma information was not provided due to immateriality.

**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES**

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

## a. Use of estimates:

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates, judgments and assumptions. 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.

## b. Financial statements in United States dollars:

The currency of the primary economic environment in which the operations of Sapiens and certain subsidiaries are conducted is the U.S. dollar ("dollar"); thus, the dollar is the functional currency of Sapiens and certain subsidiaries.

Sapiens and certain subsidiaries' transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to dollars in accordance with ASC 830, "Foreign Currency Matters". All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of income as financial income or expenses, as appropriate.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

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

For those subsidiaries whose functional currency has been determined to be their local currency, assets and liabilities are translated at year-end exchange rates and statement of income items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of accumulated other comprehensive income (loss) in shareholders' equity.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. 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.

Redeemable non-controlling interests are classified as mezzanine equity, separate from permanent equity, on the consolidated balance sheets and measured at each reporting period at the higher of their redemption amount or the non-controlling interest book value, in accordance with the requirements of Accounting Standards Codification ("ASC") 810 "Consolidation" and ASC 480-10-S99-3A, "Distinguishing Liabilities from Equity".

d. Cash equivalents:

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

e. Restricted cash:

The Company maintains certain cash amounts restricted as to withdrawal or use. On December 31, 2013, and December 31, 2014, the Company maintained a balance of \$ 782 and \$ 484 respectively that represents security deposits with respect to lease agreements and credit lines from banks. Restricted cash is included within other receivables and prepaid expenses.

f. Marketable securities:

The Company accounts for all its investments in debt securities, in accordance with ASC 320, "Investments - Debt and Equity Securities". The Company classifies all debt securities as "available-for-sale". All of the Company's investments in available-for-sale securities are reported at fair value. Unrealized gains and losses are comprised of the difference between fair value and the amortized cost of such securities and are recognized, net of tax, in accumulated other comprehensive income (loss).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest on securities is included in "financial income, net".

The Company recognizes an impairment charge when a decline in the fair value of its investments in debt securities below the cost basis of such securities is judged to be other-than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period and the Company's intent to sell, including whether it is more likely than not that the Company will be required to sell the investment before recovery of cost basis. For securities that are deemed other-than-temporarily impaired, the amount of impairment is recognized in "net gain on sale of marketable securities previously impaired" in the statements of income and is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income. During 2014 the Company did not recognize an impairment charge as the decline in fair value of its investment in marketable securities is not judged to be other-than-temporary.

## g. Property and equipment, net:

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

|                                    | %      |
|------------------------------------|--------|
| Computers and peripheral equipment | 33     |
| Office furniture and equipment     | 6 - 20 |

Leasehold improvements are amortized by the straight-line method over the term of the lease (including option terms that are deemed to be reasonably assured) or the estimated useful life of the improvements, whichever is shorter.

## h. Research and development costs:

Research and development costs incurred in the process of software production before establishment of technological feasibility are charged to expenses as incurred. Costs incurred to develop software to be sold are capitalized after technological feasibility is established in accordance with ASC 985-20, "Software - Costs of Software to be Sold, Leased, or Marketed". Based on the Company's product development process, technological feasibility is established upon completion of a detailed program design.

Costs incurred by the Company between completion of the detailed program design and the point at which the product is ready for general release, have been capitalized.

Capitalized software development costs are amortized by the straight-line method over the estimated useful life of the software product (between 5-7 years).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

## i. Other intangible assets, net:

Technology and Patent are amortized over their estimated useful life on a straight-line basis. The acquired customer relationships are amortized over their estimated useful lives in proportion to the economic benefits realized or the straight-line method. The weighted average annual rates for other intangible assets are as follows:

|                        | %  |
|------------------------|----|
| Technology             | 15 |
| Customer relationships | 14 |
| Patent                 | 10 |

## j. Impairment of long-lived assets:

The Company's long-lived assets and identifiable intangibles that are subject to amortization 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 2012, 2013 and 2014, no impairment losses have been identified.

## k. Goodwill:

Goodwill represents the excess of the purchase price in a business combination over the fair value of the net tangible and intangible assets acquired. Under ASC 350, "Intangibles- Goodwill and Other" ("ASC 350"), goodwill is subject to an annual impairment test or more frequently if impairment indicators are present. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. The Company operates in four reporting units: Sapiens, FIS, Decision and IDIT.

The Company applied the provisions of ASC 350 for the Company's annual impairment test. Under the provisions, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary.

The Company performed annual impairment tests during the fourth quarter of each of 2012, 2013 and 2014. This analysis determined that no indicators of impairment existed.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

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

## 1. Revenue recognition:

The Company generates revenues from sales of software licenses which normally include significant implementation services that are considered essential to the functionality of the software license. In addition, the Company generates revenues from post implementation consulting services and maintenance services.

Revenues are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectability is probable. The Company considers all arrangements with payment terms extending beyond six months from the delivery of the elements not to be fixed or determinable. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer, provided that all other revenue recognition criteria have been met.

The Company usually sells its software licenses as part of an overall solution offered to a customer that combines the sale of software licenses which normally include significant implementation that is considered essential to the functionality of the license. The Company accounts for revenues from the services (either fixed price or Time and Materials (T&M)) together with the software under contract accounting using the percentage-of-completion method in accordance with ASC 605-35, "Construction-Type and Production-Type Contracts". The percentage of completion method is used when the required services are quantifiable, based on the estimated number of labor hours necessary to complete the project, and under that method revenues are recognized using labor hours incurred as the measure of progress towards completion.

In accordance with ASC 985-605, the Company establishes Vendor Specific Objective Evidence ("VSOE") of fair value of maintenance services (PCS) based on the Bell-Shaped approach and determined VSOE for PCS, based on the price charged when the element is sold separately (that is, the actual renewal rate). The Company's process for establishing VSOE of fair value of PCS is through performance of VSOE compliance test which is an analysis of the entire population of PCS renewal activity for its installed base of customers.

Provisions for estimated losses on contracts in progress are made in the period in which they are first determined, in the amount of the estimated loss on the entire contract.

Maintenance revenue is recognized ratably over the term of the maintenance agreement. Deferred revenues and customer advances include unearned amounts received under maintenance and support agreements and amounts received from customers, for which revenues have not yet been recognized.

In addition, the Company derives a significant portion of its revenues from post implementation consulting services provided on a "Time and Materials" ("T&M") basis which are recognized as services are performed.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

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

## m. Income taxes:

The Company accounts for income taxes in accordance with ASC 740, "Income Taxes". This topic prescribes the use of the asset and liability method, whereby deferred tax asset 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 provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

The Company implements a two-step approach to recognize and measure uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% (cumulative basis) likely to be realized upon ultimate settlement.

The Company classifies interest as financial expenses and penalties as selling, marketing, general and administration expenses.

## n. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, restricted cash, trade receivables, marketable securities and foreign currency derivative contracts.

The Company's cash and cash equivalents and restricted cash are invested in bank deposits mainly in dollars, with a significant portion also invested in NIS. Deposits in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Generally, these banks deposits may be redeemed upon demand and therefore bear minimal risk.

The Company's trade receivables are generally derived from sales to large and solid organizations located mainly in North America, Israel, United Kingdom, Rest of Europe and Asia Pacific. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. In certain circumstances, the Company may require prepayment. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. Provisions for doubtful accounts were recorded in selling, marketing, general and administrative expenses.

The Company's marketable securities include investment in corporate debentures. The Company's investment policy limits the amount that the Company may invest in any one type of investment or issuer, thereby reducing credit risk concentrations.

The Company entered into forward contracts, and option contracts intended to protect against the increase in value of forecasted non-dollar currency cash flows. The derivative instruments hedge a portion of the Company's non-dollar currency exposure.

No off-balance sheet concentrations of credit risk exist.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

## o. Accrued severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to Israel's Severance Pay Law based on the most recent monthly salary of the employees multiplied by the number of years of employment as of the balance sheet date. Employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability is fully provided by monthly deposits with insurance policies and severance pay funds and by an accrual.

The deposited funds include profits (losses) accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or employment agreements. The value of the deposited funds is based on the cash surrendered value of these policies and recorded as an asset in the Company's consolidated balance sheets.

In addition, the Company signed on a collective agreement with certain employees, according to which the Company's contributions for severance pay shall be instead of severance compensation and that upon release of the policy to the employee, no additional payments shall be made by the Company to the employee. Generally, the Company, under its sole discretion, pays to these employees the entire liability, irrespective of the collective agreement described per above. Therefore, the net obligation related to those employees is stated on the balance sheet as accrued severance pay.

The Company's agreements with certain employees in Israel are in accordance with Section 14 of the Severance Pay Law, 1963, whereas, the Company's contributions for severance pay shall be instead of its severance liability. Upon contribution of the full amount of the employee's monthly salary, and release of the policy to the employee, no additional calculations shall be conducted between the parties regarding the matter of severance pay and no additional payments shall be made by the Company to the employee. Further, the related obligation and amounts deposited on behalf of such obligation are not stated on the balance sheet, as they are legally released from obligation to employees once the deposit amounts have been paid.

Severance expense for the years 2012, 2013 and 2014 amounted to \$ 2,217, \$ 2,909 and \$3,022, respectively.

## p. Basic and diluted net earnings per share:

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



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

## q. Stock-based compensation:

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation - Stock Compensation" ("ASC 718"), which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made. 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 statements of income.

The Company uses the Binomial Lattice ("Binomial model") option-pricing model to estimate the fair value for any options granted. The Binomial model takes into account variables such as volatility, dividend yield rate, and risk free interest rate and also allows for the use of dynamic assumptions and considers the contractual term of the option, the probability that the option will be exercised prior to the end of its contractual life, and the probability of termination or retirement of the option holder in computing the value of the option.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting, based on the straight-line basis over the requisite service period of the award, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

The fair value of each option granted in 2012, 2013 and 2014 using the Binomial model, was estimated on the date of grant with the following assumptions:

|  | Year ended December 31, |            |             |
|--|-------------------------|------------|-------------|
|  | 2012                    | 2013       | 2014        |
| Contractual life                       | 6 years                 | 6 years    | 6 years     |
| Expected exercise factor               | 1.5-2                   | 1.5-2      | 1.5-2       |
| Dividend yield                         | 0%                      | 0%         | 0%          |
| Expected volatility (weighted average) | 60%                     | 54.29%     | 48.94%      |
| Risk-free interest rate                | 0.2%-1.0%               | 0.95%-2.1% | 1.82%-1.85% |

The risk-free interest rate assumption is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term as of the Company's employee stock options. Since dividend payment is applied to reduce the exercise price of the option, the effect of the dividend protection is reflected by using an expected dividend assumption of zero. The expected life of options granted is derived from the output of the option valuation model and represents the period of time the options are expected to be outstanding. The expected exercise factor is based on industry acceptable rates since no actual historical behavior by option holders exists. Expected volatility is based on the historical volatility of the Company.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

Stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense on a straight-line basis over the requisite service period for each of the awards.

## r. Fair value of financial instruments:

ASC 820, "Fair Value Measurements and Disclosures" ("ASC 820"), defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date.

In determining fair value, the Company uses various valuation approaches. ASC 820 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

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.

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 - Valuations based on quoted prices in active markets for identical assets that the Company has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

Level 2 - Valuations based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 - Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The Company measures its marketable debt securities and foreign currency derivative instruments at fair value. The Company's marketable debts securities are traded in markets that are not considered to be active, but are valued based on quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency and accordingly are categorized as Level 2.

Foreign currency derivative contracts are classified within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

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

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, and accounts payable approximate fair value due to the short-term maturities of such instruments.

s. Derivatives and hedging:

The Company enters into option contracts and forward contracts to hedge certain transactions denominated in foreign currencies. The purpose of the Company's foreign currency hedging activities is to protect the Company from risk that the eventual dollar cash flows from international activities will be adversely affected by changes in the exchange rates. The Company's option and forward contracts do not qualify as hedging instruments under ASC 815, "Derivatives and hedging". Changes in the fair value of option strategies are reflected in the consolidated statements of income as financial income or expense.

In 2012, 2013 and 2014, the Company entered into option strategies contracts in the notional amounts of \$ 10,408, \$ 9,868 and \$ 33,270, respectively and in 2012, 2013 and 2014, the Company entered into forward contracts in the notional amounts of \$ 1,734, \$ 299 and \$ 7,383, respectively, in order to protect against foreign currency fluctuations.

As of December 31, 2013 and 2014, the Company had outstanding options and forward contracts, in the notional amount of \$ 2,982 and \$ 25,772, respectively.

In 2012, 2013 and 2014, the Company recorded an income (expenses) of \$ 97, \$ 387 and \$ (397), respectively, with respect to the above transactions, presented in the statements of income as financial income (expenses).

t. Treasury shares:

Repurchased common shares are held as treasury shares. The Company presents the cost to repurchase treasury stock as a reduction of shareholders' equity.

u. Comprehensive income:

The Company accounts for comprehensive income in accordance with ASC 220, "Comprehensive Income". Comprehensive income generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

The components of accumulated other comprehensive income (loss), in the amount of \$ 1,082 and \$ (10,281) at December 31, 2013 and 2014, respectively, were as follows:

|   | December 31,    |                    |
|---|-----------------|--------------------|
|   | 2013            | 2014               |
| Foreign currency translation differences                                  | \$ 1,082        | \$ (10,126)        |
| Unrealized losses on available-for-sale marketable securities, net of tax | -               | (155)              |
|   | <u>\$ 1,082</u> | <u>\$ (10,281)</u> |

## v. Reclassification:

Certain amounts in prior years' financial statements have been reclassified to conform to the current year's presentation.

## w. Impact of recently issued accounting standards:

On May 28, 2014, the FASB completed its Revenue Recognition project by issuing ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The new guidance establishes the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers. The new Revenue Recognition guidance is effective for annual reporting periods beginning after December 15, 2016 including interim reporting periods within that reporting period. Early application is not permitted. The Company is currently evaluating the method of adoption, as well as the effect that adoption of this ASU will have on its consolidated financial statements.

**NOTE 3: MARKETABLE SECURITIES**

As of December 31, 2014, the fair value, Amortized cost and gross unrealized holding gains and losses of available-for-sale marketable securities were as follows:

|   | December 31, 2014 |                              |                               |                  |
|---|-------------------|------------------------------|-------------------------------|------------------|
|   | Amortized<br>Cost | Gross<br>unrealized<br>Gains | Gross<br>Unrealized<br>losses | Fair<br>value    |
| Government debentures – fixed interest rate | \$ 5,161          | -                            | \$ (33)                       | \$ 5,128         |
| Corporate debentures – fixed interest rate  | \$ 28,148         | -                            | \$ (178)                      | \$ 27,970        |
|   | <u>\$ 33,309</u>  | <u>-</u>                     | <u>\$ (211)</u>               | <u>\$ 33,098</u> |

The contractual maturities of available-for-sale marketable securities are between 1 to 3 years.

As of December 31, 2014, interest receivable included in other receivables and prepaid expenses amounted to \$ 280.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 4: OTHER LONG TERM ASSETS**

|                        | December 31,    |                 |
|------------------------|-----------------|-----------------|
|                        | 2013            | 2014            |
| Deferred tax assets    | \$ 396          | \$ 695          |
| Government authorities | 1,917           | 1,688           |
| Other                  | 644             | 865             |
|                        | <u>\$ 2,957</u> | <u>\$ 3,248</u> |

**NOTE 5: PROPERTY AND EQUIPMENT, NET**

|                                    | December 31,    |                 |
|------------------------------------|-----------------|-----------------|
|                                    | 2013            | 2014            |
| Cost:                              |                 |                 |
| Computers and peripheral equipment | \$ 12,190       | \$ 12,197       |
| Office furniture and equipment     | 4,183           | 3,908           |
| Leasehold improvements             | 2,959           | 2,811           |
|                                    | <u>19,332</u>   | <u>18,916</u>   |
| Accumulated depreciation:          |                 |                 |
| Computers and peripheral equipment | 9,964           | 10,265          |
| Office furniture and equipment     | 2,609           | 2,459           |
| Leasehold improvements             | 1,496           | 1,429           |
|                                    | <u>14,069</u>   | <u>14,153</u>   |
| Depreciated cost                   | <u>\$ 5,263</u> | <u>\$ 4,763</u> |

Depreciation expense totaled \$ 903, \$ 1,260 and \$ 1,582 for the years 2012, 2013 and 2014, respectively.

**NOTE 6: CAPITALIZED SOFTWARE DEVELOPMENT COSTS, NET**

The changes in capitalized software development costs during the year ended December 31, 2013 and 2014 were as follows:

|   | Year ended December 31, |                  |
|---|-------------------------|------------------|
|   | 2013                    | 2014             |
| Balance at the beginning of the year        | \$ 17,494               | \$ 19,704        |
| Capitalization                              | 5,392                   | 6,094            |
| Amortization                                | (4,500)                 | (4,926)          |
| Functional currency translation adjustments | 1,318                   | (2,192)          |
| Balance at the year end                     | <u>\$ 19,704</u>        | <u>\$ 18,680</u> |

Amortization of capitalized software development costs for 2012, 2013 and 2014, was \$ 3,758, \$ 4,500 and \$ 4,926, respectively. Amortization expense is included in cost of revenues.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 7: OTHER INTANGIBLE ASSETS, NET**

- a. Other intangible assets, net, are comprised of the following:

|                                     | <b>December 31,</b>     |                        |
|-------------------------------------|-------------------------|------------------------|
|                                     | <b>2013</b>             | <b>2014</b>            |
| <b>Original amounts:</b>            |                         |                        |
| Customer relationships              | \$ 9,929                | \$ 9,845               |
| Technology                          | 6,151                   | 6,473                  |
| Patent                              | -                       | 1,234                  |
|                                     | <u>16,080</u>           | <u>17,552</u>          |
| <b>Accumulated amortization:</b>    |                         |                        |
| Customer relationships              | 3,418                   | 5,239                  |
| Technology                          | 2,352                   | 3,882                  |
| Patent                              | -                       | 51                     |
|                                     | <u>5,770</u>            | <u>9,172</u>           |
| <b>Other intangible assets, net</b> | <u><b>\$ 10,310</b></u> | <u><b>\$ 8,380</b></u> |

- b. Amortization of other intangible assets was \$ 2,732, \$ 2,127 and \$ 2,209 for 2012, 2013 and 2014, respectively.

- c. Estimated amortization expense for future periods:

**For the year ended December 31,**

|                     |                        |
|---------------------|------------------------|
| 2015                | \$ 2,074               |
| 2016                | 1,753                  |
| 2017                | 1,635                  |
| 2018                | 1,267                  |
| 2019                | 623                    |
| 2020 and thereafter | 1,028                  |
|                     | <u><u>\$ 8,380</u></u> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 8:- GOODWILL**

The changes in the carrying amount of goodwill for the years ended December 31, 2013 and 2014 are as follows:

|   | <b>Year ended December 31,</b> |                  |
|---|--------------------------------|------------------|
|   | <b>2013</b>                    | <b>2014</b>      |
| Balance at the beginning of the year        | \$ 68,087                      | \$ 72,438        |
| Acquisition of KPI                          | -                              | 613              |
| Functional currency translation adjustments | 4,351                          | (5,353)          |
| Balance at the year end                     | <u>\$ 72,438</u>               | <u>\$ 67,698</u> |

**NOTE 9: ACCRUED EXPENSES AND OTHER LIABILITIES**

|   | <b>December 31,</b> |                  |
|---|---------------------|------------------|
|   | <b>2013</b>         | <b>2014</b>      |
| Government authorities                  | \$ 3,084            | \$ 3,287         |
| Accrued royalties to the OCS (Note 10a) | 269                 | 283              |
| Accrued expenses                        | 3,637               | 6,970            |
|   | <u>\$ 6,990</u>     | <u>\$ 10,540</u> |

**NOTE 10: COMMITMENTS AND CONTINGENT LIABILITIES**

- a. Sapiens Technologies (1982) Ltd. ("Sapiens Technologies"), a subsidiary incorporated in Israel, was partially financed under programs sponsored by the Office of Chief Scientist ("OCS") for the support of certain research and development activities conducted in Israel.

In exchange for participation in the programs by the OCS, the Company agreed to pay 3.5% of total net consolidated license and maintenance revenue and 0.35% of the net consolidated consulting services revenue related to the software developed within the framework of these programs based on an understanding with the OCS reached in January 2012.

The royalties will be paid up to a maximum amount equaling 100%-150% of the grants provided by the OCS, linked to the dollar, and for grants received after January 1, 1999, bear annual interest at a rate based on LIBOR.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10: COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

Royalties' expenses amounted to \$574, \$514 and \$ 618 in 2012, 2013 and 2014, respectively, and are included in cost of revenues.

As of December 31, 2014, the Company had a contingent liability to pay royalties of \$7,576.

## b. Lease commitments:

The Company leases office space, office equipment and various motor vehicles under operating leases.

1. The Company's office space and office equipment are rented under several operating leases. Future minimum lease commitments under non-cancelable operating leases for the years ended December 31, were as follows:

|                     |           |               |
|---------------------|-----------|---------------|
| 2015                | \$        | 3,851         |
| 2016                |           | 3,638         |
| 2017                |           | 3,223         |
| 2018                |           | 3,078         |
| 2019                |           | 2,799         |
| 2020 and thereafter |           | 1,118         |
|                     | <u>\$</u> | <u>17,707</u> |

Rent expense for the years ended December 31, 2012, 2013 and 2014 was \$ 3,051, \$ 3,370 and \$ 3,782 respectively.

2. The Company leases its motor vehicles under cancelable operating lease agreements.

The minimum payment under these operating leases, upon cancellation of these lease agreements was \$ 149 as of December 31, 2014.

- c. The Company has provided bank guarantees in the amount of \$ 1,161 as security for the rent to be paid for its leased offices. The lease is valid for approximately two and a half years ending in December 2015. As of December 31, 2014, the Company had restricted bank deposits of \$ 484 in favor of the bank guarantees.

As of December 31, 2014, the Company has provided bank guarantees in the amount of \$182 as security for the performance of various contracts with customers and suppliers.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11: TAXES ON INCOME**

## a. Parent taxation:

Sapiens is governed under the laws of Curaçao. In addition, Sapiens is registered as an Israeli corporation for tax purposes only.

## b. Israeli taxation:

## 1. Corporate tax rates in Israel:

Taxable income of Israeli companies is subject to tax at the rate of 25% in 2012 and 2013, and 26.5% in 2014 and thereafter.

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

Certain of the Company's Israeli subsidiaries have been granted "Approved Enterprise" and "Beneficiary Enterprise" status, which provides certain benefits, including tax exemptions and reduced tax rates. Income not eligible for Approved Enterprise and Beneficiary Enterprise benefits is taxed at regular rates.

The entitlement to the above benefits is conditional upon the fulfilling of the conditions stipulated by the Laws and regulations. Should the certain Israeli subsidiaries fail to meet such requirements in the future, income attributable to their Approved Enterprise and Beneficiary Enterprise programs could be subject to the statutory Israeli corporate tax rate and they could be required to refund a portion of the tax benefits already received, with respect to such programs. As of December 31, 2014, management believes that these subsidiaries are in compliance with all the conditions required by the Law.

Effective January 1, 2011, the Knesset enacted the Law for Economic Policy for 2011 and 2012 (Amended Legislation), and among other things, amended the Law, ("the Amendment"). According to the Amendment, the benefit tracks in the Investment Law were modified and a flat tax rate applies to the Company's entire preferred income. The Company is able to opt to apply (the waiver is non-recourse) the Amendment and from then on it will be subject to the amended tax rate of 16%.

Under the terms of the Approved Enterprise program, income that is attributable to one of The Company's Israeli subsidiaries will be exempt from income tax for a period of two years commencing 2014. The tax holiday has resulted in a tax savings of approximately \$1,900 in the year ended December 31, 2014. If such tax-exempt income is distributed in a manner other than upon complete liquidation of the Company, it would be taxed at the reduced corporate tax rate applicable to such profits (25%), and an income tax liability of up to approximately \$1,800 would be incurred as of December 31, 2014.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

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**NOTE 11: TAXES ON INCOME (Cont.)**

## 3. Foreign Exchange Regulations:

Under the Foreign Exchange Regulations, some of the Company's Israeli subsidiaries calculate their tax liability in U.S. Dollars according to certain orders. The tax liability, as calculated in U.S. Dollars is translated into NIS according to the exchange rate as of December 31st of each year.

## c. Income taxes on non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed according to the tax laws in their respective country of residence. Neither Israeli income taxes, foreign withholding taxes nor deferred income taxes were provided in relation to undistributed earnings of the non-Israelis subsidiaries. This is because the Company intends to permanently reinvest undistributed earnings in the foreign subsidiaries in which those earnings arose. If these earnings were distributed in the form of dividends or otherwise, the Company would be subject to additional Israeli income taxes (subject to an adjustment for foreign tax credits) and non-Israeli withholding taxes.

The amount of undistributed earnings of foreign subsidiaries that are considered to be reinvested as of December 31, 2014 was \$ 9,926 and the amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries that were essentially permanent in duration as of December 31, 2014 was \$207.

## d. Net operating losses carry forward:

As of December 31, 2014, certain subsidiaries had tax loss carry-forwards totaling approximately \$ 38,800. Most of these carry-forward tax losses have no expiration date.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11: TAXES ON INCOME (Cont.)**

## e. Deferred tax assets and liabilities:

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

|  | <b>December 31,</b> |                 |
|--|---------------------|-----------------|
|  | <b>2013</b>         | <b>2014</b>     |
| Deferred tax assets:                           |                     |                 |
| Net operating losses carry forward             | \$ 12,080           | \$ 8,915        |
| Research and development                       | 2,592               | 2,028           |
| Other  | 1,132               | 1,462           |
| Deferred tax assets before valuation allowance | 15,804              | 12,405          |
| Valuation allowance                            | (8,324)             | (6,136)         |
| Deferred tax assets                            | <u>7,480</u>        | <u>6,269</u>    |
| Deferred tax liabilities:                      |                     |                 |
| Capitalized software development costs         | (3,203)             | (2,474)         |
| Acquired intangibles                           | (2,854)             | (1,546)         |
| Property and equipment                         | -                   | (68)            |
| Deferred tax liabilities                       | <u>(6,057)</u>      | <u>(4,088)</u>  |
| Deferred tax assets, net                       | <u>\$ 1,423</u>     | <u>\$ 2,181</u> |
|  |                     |                 |
|  | <b>December 31,</b> |                 |
|  | <b>2013</b>         | <b>2014</b>     |
| Current deferred tax assets                    | \$ 2,420            | \$ 2,319        |
| Long-term deferred tax assets                  | 396                 | 695             |
| Long-term deferred tax liabilities             | <u>(1,393)</u>      | <u>(833)</u>    |
| Deferred tax assets, net                       | <u>\$ 1,423</u>     | <u>\$ 2,181</u> |

Long-term deferred tax assets are included within other long-term assets in the balance sheets. Long-term deferred tax liabilities are included within other long-term liabilities in the balance sheets.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11: TAXES ON INCOME (Cont.)**

The Company has provided valuation allowances in respect of certain deferred tax assets resulting from tax loss carry forwards and other reserves and allowances due to uncertainty concerning realization of these deferred tax assets.

- f. Income before taxes on income is comprised as follows:

|                    | <b>Year ended December 31,</b> |                  |                  |
|--------------------|--------------------------------|------------------|------------------|
|                    | <b>2012</b>                    | <b>2013</b>      | <b>2014</b>      |
| Domestic (Curaçao) | \$ (745)                       | \$ (875)         | \$ (643)         |
| Foreign            | 12,983                         | 13,278           | 15,673           |
|                    | <u>\$ 12,238</u>               | <u>\$ 12,403</u> | <u>\$ 15,030</u> |

- g. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income for an Israeli company, and the actual tax expense as reported in the statements of income is as follows:

|   | <b>Year ended December 31,</b> |                  |                  |
|---|--------------------------------|------------------|------------------|
|   | <b>2012</b>                    | <b>2013</b>      | <b>2014</b>      |
| Income before taxes on income, as reported in the statements of income  | <u>\$ 12,238</u>               | <u>\$ 12,403</u> | <u>\$ 15,030</u> |
| Statutory tax rate in Israel  | <u>25%</u>                     | <u>25%</u>       | <u>26.5%</u>     |
| Theoretical taxes on income   | \$ 3,018                       | \$ 3,097         | \$ 3,983         |
| Increase (decrease) in taxes resulting from:  |                                |                  |                  |
| Effect of different tax rates   | 120                            | 158              | 362              |
| Effect of "Approved, Beneficiary or Preferred Enterprise" status  | -                              | -                | (2,323)          |
| Utilization of carry forward tax losses for which valuation allowance was provided  | (2,690)                        | (1,162)          | (1,177)          |
| Non-deductible expenses   | 82                             | 9                | 80               |
| Recognition of deferred taxes during the year for which valuation allowance was provided in prior years                               | (1,206)                        | (971)            | (1,496)          |
| Losses and temporary differences for which valuation allowance was provided   | 421                            | 222              | 580              |
| Others  | 690                            | (542)            | 445              |
| Taxes on income, as reported in the statements of income  | <u>\$ 435</u>                  | <u>\$ 811</u>    | <u>\$ 454</u>    |
| Basic and diluted earnings per share amounts of the benefit resulting from the "Approved, Beneficiary or Preferred Enterprise" status | <u>-</u>                       | <u>-</u>         | <u>\$ 0.05</u>   |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11: TAXES ON INCOME (Cont.)**

- h. Taxes on income are comprised as follows:

|          | <b>Year ended December 31,</b> |               |               |
|----------|--------------------------------|---------------|---------------|
|          | <b>2012</b>                    | <b>2013</b>   | <b>2014</b>   |
| Current  | \$ 738                         | \$ 400        | \$ 1,474      |
| Deferred | (303)                          | 411           | (1,020)       |
|          | <u>\$ 435</u>                  | <u>\$ 811</u> | <u>\$ 454</u> |

The Company's entire provision for taxes on income relates to operations in jurisdictions other than Curaçao.

- i. Uncertain tax positions:

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

|                                      | <b>December 31,</b> |               |
|--------------------------------------|---------------------|---------------|
|                                      | <b>2013</b>         | <b>2014</b>   |
| Balance at the beginning of the year | \$ 510              | \$ 652        |
| Increase in tax positions            | 199                 | 190           |
| Decrease in tax positions            | (57)                | (137)         |
| Balance at the end of the year       | <u>\$ 652</u>       | <u>\$ 705</u> |

The entire balance of unrecognized tax benefits, if recognized, would reduce the Company's annual effective tax rate.

As of December 31, 2013 and 2014 accrued interest related to uncertain tax positions amounted to \$ 200 and \$ 198, respectively.

As of December 31, 2014, most of the Company's Israeli subsidiaries are subject to Israeli income tax audits for the tax years 2009 through 2014, to U.S. federal income tax audits for the tax years 2009 through 2014 and to other for the tax years 2006 through 2014.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

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**NOTE 12: EQUITY**

- a. The common shares of the Company are traded on the Tel-Aviv Stock Exchange and on the NASDAQ.

Common shares confer upon their holders voting rights, the right to receive cash dividends and the right to share in excess assets upon liquidation of the Company.

On November 14, 2013 the Company completed a secondary public offering of its ordinary shares on the NASDAQ. The Company issued 6,497,400 shares at a price of \$ 6.25 per share before issuance expenses. Total net proceeds from the issuance amounted to \$ 37,791.

- b. Stock option plans:

In 2011, in connection with the acquisition of IDIT and FIS, the Company's board of directors approved its 2011 Share Incentive Plan (the "2011 Plan") pursuant to which the Company's employees, directors, officers, consultants, advisors, suppliers, business partner, customer and any other person or entity whose services are considered valuable are eligible to receive awards of share options, restricted shares, restricted share units and other share-based awards. Options granted under the 2011 Plan may be exercised for a period of up to 6 years from the date of grant and become exercisable in four equal, annual installments, beginning with the first anniversary of the date of the grant, or pursuant to such other schedule as may provide in the option agreement.

The total number of Common Shares available under the 2011 Plan was set at 4,000,000. Upon the approval of the 2011 Plan, the board of directors determined that no further awards would be issued under the Company's previously existing share incentive plans.

As of December 31, 2014 605,321 common shares of the Company were available for future grant under the 2011 Plan. Any option granted under the 2011 Plan which are forfeited, cancelled, terminated or expired, will become available for future grant under the 2011 Plan.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12: EQUITY (Cont.)**

A summary of the stock option activities in 2014 is as follows:

|                                  | Year ended December 31, 2014 |                                 |  |                           |
|----------------------------------|------------------------------|---------------------------------|--|---------------------------|
|                                  | Amount of options            | Weighted average exercise price | Weighted average remaining contractual life (in years) | Aggregate intrinsic value |
| Outstanding at January 1, 2014   | 3,878,495                    | \$ 2.57                         | 3.38   | \$ 19,949                 |
| Granted                          | 340,000                      | 7.61                            |  |                           |
| Exercised                        | (1,225,368)                  | 1.81                            |  |                           |
| Expired and forfeited            | (197,046)                    | 2.85                            |  |                           |
| Outstanding at December 31, 2014 | <u>2,796,081</u>             | <u>3.49</u>                     | <u>3.07</u>  | <u>10,957</u>             |
| Exercisable at December 31, 2014 | <u>1,817,761</u>             | <u>\$ 2.27</u>                  | <u>2.24</u>  | <u>\$ 9,277</u>           |

In 2012, 2013 and 2014, the Company granted 432,805, 595,000 and 340,000 stock options to employees and directors, respectively.

The weighted average grant date fair values of the options granted during the years ended December 31, 2012, 2013 and 2014 were \$ 1.96, \$ 2.51 and \$ 3.19, respectively.

The total intrinsic value of options exercised during the years ended December 31, 2012, 2013 and 2014 was \$ 2,668, \$ 2,839 and \$ 7,446, respectively.

The options outstanding under the Company's stock option plans as of December 31, 2014 have been separated into ranges of exercise price as follows:

| Ranges of exercise price | Options outstanding as of December 31, 2014 | Weighted Average remaining contractual Term (Years) | Weighted average exercise price \$ | Options Exercisable as of December 31, 2014 | Weighted Average Exercise price of Options Exercisable \$ |
|--------------------------|---|---|------------------------------------|---|---|
| 0.85-1.45                | 971,368                                     | 0.71  | 1.33                               | 971,368                                     | 1.33  |
| 1.63                     | 113,056                                     | 4.06  | 1.63                               | 113,056                                     | 1.63  |
| 2.09-2.41                | 121,754                                     | 5.81  | 2.38                               | 121,754                                     | 2.38  |
| 2.85                     | 208,932                                     | 2.97  | 2.85                               | 208,932                                     | 2.85  |
| 3.60-3.69                | 435,805                                     | 3.90  | 3.69                               | 209,152                                     | 3.69  |
| 3.92                     | 45,166                                      | 2.49  | 3.92                               | 45,166                                      | 3.92  |
| 4.87-5.00                | 343,000                                     | 4.36  | 4.91                               | 85,750                                      | 4.91  |
| 5.40-5.68                | 90,000                                      | 4.55  | 5.48                               | 22,500                                      | 5.48  |
| 6.42                     | 100,000                                     | 4.85  | 6.42                               | 33,333                                      | 6.42  |
| 7.16-7.83                | 367,000                                     | 5.22  | 7.61                               | 6,750                                       | 7.66  |
|                          | <u>2,796,081</u>                            | <u>3.07</u>   | <u>3.49</u>                        | <u>1,817,761</u>                            | <u>2.27</u>   |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12: EQUITY (Cont.)**

- c. As of December 31, 2014, there was \$ 2,069 of total unrecognized compensation cost related to non-vested options, which is expected to be recognized over a period of up to four years.

- d. Warrants:

The following table summarizes information regarding outstanding warrants to purchase Common shares of the Company as of December 31, 2014:

| Warrants to<br>Common<br>shares | Weighted average<br>exercise price per<br>share | Warrants<br>exercisable | Exercisable through |
|---------------------------------|---|-------------------------|---------------------|
| 11,000                          | 2.00  | 11,000                  | May - 15            |
| 17,000                          | 2.24  | 17,000                  | February - 15       |
| <u>28,000</u>                   | <u>2.15</u>                                     | <u>28,000</u>           |                     |

- e. Repurchase of shares:

On November 29, 2012, the Company repurchased from one of its shareholders 2,000,000 common shares, representing approximately 5% of the total number of issued and outstanding common shares, at a price of \$ 3.50 per share, for a total consideration of \$7,000. The repurchased shares are held as treasury shares.

- f. Dividend:

On February 20, 2013, the Company's extraordinary general meeting of shareholders approved the distribution of cash dividend of \$ 0.15 per common share for a total amount of \$ 5,802 which was paid on February 22, 2013.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- BASIC AND DILUTED NET EARNINGS PER SHARE**

|  | Year ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2012                    | 2013      | 2014      |
| Numerator:   |                         |           |           |
| Net income attributed to Sapiens shareholders  | \$ 11,780               | \$ 11,604 | \$ 14,463 |
| Denominator (thousands):   |                         |           |           |
| Denominator for basic earnings per share - weighted average number of common shares, net of treasury stock | 39,953                  | 40,024    | 47,210    |
| Shares and related put options issued in Harcase acquisition   | 114                     | -         | -         |
| Stock options and warrants   | 1,604                   | 2,292     | 1,427     |
| Denominator for diluted net earnings per share - adjusted weighted average number of shares                | 41,671                  | 42,316    | 48,637    |

The weighted average number of shares related to outstanding anti-dilutive options and warrants excluded from the calculations of diluted net earnings per share was 1,675,521, 466,534 and 599,287 for the years 2012, 2013 and 2014, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 14: GEOGRAPHIC INFORMATION**

- a. The Company operates in a single reportable segment as a provider of software solutions. See Note 1 for a brief description of the Company's business. The data below is presented in accordance with ASC 280, "Segment Reporting".
- b. Geographic information:

The following table sets forth revenues by country based on the billing address of the customer. Other than as shown below, no other country accounted for more than 10% of the Company's revenues during the years ended December 31, 2012, 2013 and 2014.

|                | Year ended December 31, |                   |                   |
|----------------|-------------------------|-------------------|-------------------|
|                | 2012                    | 2013              | 2014              |
| 1. Revenues:   |                         |                   |                   |
| North America* | \$ 35,519               | \$ 44,237         | \$ 49,585         |
| United Kingdom | 26,630                  | 31,115            | 34,961            |
| Israel         | 23,100                  | 23,009            | 28,821            |
| Rest of Europe | 16,140                  | 24,862            | 28,351            |
| Asia Pacific   | 12,520                  | 12,154            | 15,732            |
|                | <u>\$ 113,909</u>       | <u>\$ 135,377</u> | <u>\$ 157,450</u> |

- \* Revenue amounts for North America that are shown in the above table consist primarily of revenues from the United States, except for approximately \$1,900, \$1,100 and \$558 of revenues derived from Canada in the years ended December 31, 2012, 2013 and 2014, respectively.

|                            | December 31,    |                 |
|----------------------------|-----------------|-----------------|
|                            | 2013            | 2014            |
| 2. Property and equipment: |                 |                 |
| Israel                     | \$ 4,180        | \$ 3,722        |
| North America              | 231             | 146             |
| Rest of the world          | 852             | 895             |
|                            | <u>\$ 5,263</u> | <u>\$ 4,763</u> |

- c. Major customer data:

The following table sets forth revenues from major customers during the years ended December 31, 2012, 2013 and 2014.

|            | Year ended December 31, |      |      |
|------------|-------------------------|------|------|
|            | 2012                    | 2013 | 2014 |
| Customer A | 12%                     | *)   | *)   |
| Customer B | *)                      | *)   | 11%  |

\*) Less than 10%.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 15: SELECTED STATEMENTS OF OPERATIONS DATA**

- a. Research and development expenses:

|   | <b>Year ended December 31,</b> |                  |                  |
|---|--------------------------------|------------------|------------------|
|   | <b>2012</b>                    | <b>2013</b>      | <b>2014</b>      |
| Total costs                                   | \$ 13,633                      | \$ 17,238        | \$ 17,446        |
| Less - capitalized software development costs | (3,464)                        | (5,392)          | (6,094)          |
| Research and development expenses             | <u>\$ 10,169</u>               | <u>\$ 11,846</u> | <u>\$ 11,352</u> |

- b. Financial income, net:

|                              |               |               |                |
|------------------------------|---------------|---------------|----------------|
| <b>Financial income:</b>     |               |               |                |
| Interest                     | \$ 201        | \$ 188        | \$ 356         |
| Foreign currency translation | 501           | 644           | 883            |
|                              | <u>702</u>    | <u>832</u>    | <u>1,239</u>   |
| <b>Financial expenses:</b>   |               |               |                |
| Derivatives (gains) losses   | (97)          | (387)         | 397            |
| Foreign currency translation | 284           | 155           | 586            |
| Bank charges and other       | 322           | 544           | 132            |
|                              | <u>(509)</u>  | <u>(312)</u>  | <u>(1,115)</u> |
| Financial income, net        | <u>\$ 193</u> | <u>\$ 520</u> | <u>\$ 124</u>  |

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