FORMULA SYSTEMS (1985) LTD
Form 20-F
June 29, 2006

FORM 20-F
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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

OR

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

For the fiscal year ended December 31, 2005;

OR

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

For the transition period from __________ to ___________

OR

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

Date of event requiring this shell company report ..

Commission File Number: 0-29442

FORMULA SYSTEMS (1985) LTD.

(Exact name of registrant as specified in its charter)

Israel
(Jurisdiction of incorporation or organization)

3 Abba Eban Boulevard, Herzlia 46725, Israel

(Address of principal executive offices)

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

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

American Depositary Shares

Ordinary Shares, NIS 1 par value

(Title of class)

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

American Depositary Shares

Ordinary Shares, NIS 1 par value

(Title of Class)

As of December 31, 2005, the registrant had 13,200,000 outstanding ordinary shares, NIS 1 par value, of which 412,472_were represented by American depositary shares as of such date.

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

Yes o No x

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 o No x

Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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 x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 o Item 18 x

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

Yes o No x

P A R T I

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Some of the statements in this annual report, including those in the Risk Factors, Operating and Financial Review and Prospects and Business Overview sections, are forward-looking statements that involve risks and uncertainties. These forward-looking statements include statements about our plans, objectives, strategies, expectations, intentions, future financial performance and other statements that are not historical facts. We use words like anticipates , believes , expects , future intends , and similar expressions to mean that the statement is forward-looking. You should not unduly rely on these forward-looking statements, which apply only as of the date of this annual report. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including the risks described under Risk Factors.

Beginning with the fiscal year ended December 31, 2002, we prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States, commonly referred to as U.S.GAAP. Prior to 2002, we prepared our consolidated financial statements in accordance with accounting principles generally accepted in Israel, referred to as Israeli GAAP. Israeli GAAP and U.S. GAAP vary in certain respects. As a result, we have restated certain figures in our financial statements relating to prior periods. In accordance with U.S. GAAP, we use the United States dollar as our reporting currency. Prior to 2002, we presented our consolidated financial statements in New Israeli Shekels, or NIS, that have been adjusted to reflect changes in the Israeli consumer price index, referred to as the Israeli CPI.

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

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

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

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ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

The following tables present our consolidated statement of operations and balance sheet data for the periods and as of the dates indicated. We derive the consolidated statement of operations data for the years ended December 31, 2003, 2004 and 2005, and the balance sheet data as at December 31, 2004 and 2005from our consolidated financial statements included elsewhere in this annual report. Our consolidated financial statements have been audited by Ziv Haft registered public accountants (Isr.) BDO member firm. The consolidated income statement data for the years ended December 31, 2001 and 2002 and the consolidated balance sheet data for the years ended December 31, 2001, 2002 and 2003 is derived from our audited financial statements not included in this annual report. You should read the selected consolidated financial data together with our consolidated financial statements included elsewhere in this annual report. See Item 5. Operating and Financial Review and Prospects.

We prepare our consolidated financial statements in conformity with U.S. GAAP. Under U.S. GAAP, we cannot use adjusted NIS reflecting changes in the Israeli consumer price index, as we have used in the past. Instead, we use nominal values of the NIS translated into dollars as described in Item 5 below. As a result, we have restated certain financial figures relating to 2001.

	Year Ended December 31,				
	2005	2004	2003	2002	2001
			$		
			(In thousands, except per share data)		
Consolidated Statement of Operations Data:					
Revenues	$ 506,371	$ 456,610	$ 366,830	$ 283,310	$ 387,682
Cost of revenues	333,536	284,961	230,500	186,908	261,346
Gross profit	172,835	171,649	136,330	96,402	126,336
Research and development costs, net	22,429	25,036	17,368	15,967	21,287
Selling, general and administrative expenses	133,049	128,537	107,103	85,292	151,345
Restructuring and non-recurring costs	1,455			1,829	10,998
Operating income (loss)	15,902	18,076	11,859	(6,686)	(57,294)
Financial income (expenses), net	(9,206)	(8,904)	(3,676)	3,605	2,680
Gain on realization of shareholdings, net	4,107	8,893	2,756	4,668	773
Other expenses, net	820	332	90	2,100	36,719
Income (loss) before taxes on income	9,983	17,733	10,849	(513)	(90,560)
Taxes on income	5,200	4,631	2,540	2,014	6,239
Equity in losses of affiliated companies, net	(3,109)	(2,523)	(1,071)	(2,327)	(9,926)
Minority interest in losses (profit), net	(1,491)	(2,480)	(4,118)	2,448	46,864
Net income (loss)	183	8,099	3,120	(2,406)	(59,861)
Earnings (loss) per share:					
Basic earnings (loss)	0.01	0.73	0.29	(0.24)	(6.42)
Diluted earnings (loss)	0.01	0.65	0.24	(0.24)	(6.42)
Weighted average number of shares outstanding:					
Basic	12,800	10,800	10,037	10,171	9,325
Diluted	12,800	10,800	10,285	10,171	9,325

	As of December 31,				
	2005	2004	2003	2002	2001
			$ (In thousands)		
Consolidated Balance Sheet Data:					
Total assets	630,085	641,020	544,008	467,245	454,544
Total liabilities	357, 959	357,663	299,773	241,766	192,532
Shareholders equity	163,445	186,778	176,004	153,349	166,421

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Our business, operating results and financial condition could be seriously harmed due to any of the following risks. The trading price of our ordinary shares could decline due to any of these risks.

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

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

- acquisitions and dispositions of companies and consolidation of our subsidiaries;
- the size, time and recognition of revenue from significant contracts;
- timing of product releases;
- timing of contracts;
- timing of completion of specified milestones and delays in implementation;
- changes in the proportion of service and license revenues;
- price and product competition;
- increases in selling and marketing expenses, as well as other operating expenses;
- currency fluctuations; and
- consolidation of our customers.

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

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

We are affected by global economic changes, in particular trends in capital spending in the IT sector. During 2001 through 2003, the overall business slowdown in the North American and European markets influenced the purchasing patterns of leading software developers who delayed their planned orders and caused developers to reduce the amount of their planned license commitment. These changes in purchasing patterns in the IT industry directly affected our operating results. Although we believe that during the last two years the IT market has begun to recover, we cannot know whether the global market recovery will continue in the future, and how the economic conditions will continue to affect our business. Accordingly, we cannot assure you that we will be able to increase our revenues or keep our revenues at the same level as in 2005.

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

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

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

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

- longer operating histories;
- greater financial, technical, marketing and other resources;
- greater name recognition;
- well-established relationships with our current and potential clients; and

a broader range of products and services.

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

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

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

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

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

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

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

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

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

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

If Formula Vision does not generate sufficient cash in 2006 in order to repay the entire amount of the debentures, we might be required to delay the maturity date of a portion of the amount.

In 2001 and 2002, in connection with the purchase by Formula Vision Technologies (F.V.T.) Ltd., or Formula Vision, of Formula s interests in certain privately-held companies, Formula Vision issued to Formula a series of debentures of a principal aggregate amount of $78.3 million. Under their original terms, the debentures were required to be repaid in five annual installments, subject to certain conditions. Following the exchange in January 2004, of an aggregate principal amount of $35 million of the debentures for a 59.4% interest in Formula Vision, the outstanding amount of the debentures was $43.2 million. In December 2005, the general meeting of Formula s shareholders approved an amendment to the debentures pursuant to which the repayments due in 2005 and 2006 would be deferred to December 31, 2006, subject to certain conditions. The amendment to the debentures was made since Formula Vision anticipated that it may not have sufficient liquid cash assets to satisfy the repayment under the debentures. The realization of Formula Vision s assets and its timing are subject to market conditions and other factors. As a result, we cannot be sure that Formula Vision will have sufficient cash to repay the entire amount of the debenture by the maturity date. If the cash generated by Formula Vision will not cover the full amount of the debentures, we may need to delay the maturity date with respect to a portion of the debentures. Such delay may have a negative effect on our business, operating results and financial condition.

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

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

Some of our assets are pledged to banks. These assets include certain of our shareholdings in our subsidiaries, Matrix IT Ltd., BluePhoenix Solutions Ltd. and Magic Software Enterprises Ltd. If we are unable to repay the debt, the lenders could foreclose on our assets that are subject to liens and sell these holdings to satisfy the debt.

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

We intend to continue to focus our efforts on selling proprietary software solutions in international markets. We expect to continue devoting significant resources to these efforts. If we are unable to continue achieving market acceptance for our solutions or otherwise continue to successfully penetrate international markets, our business will be harmed. In 2004 and 2005, we received approximately 53% and 52% of our total revenues from customers located outside of Israel. The expansion of our existing operations and entry into additional international markets will require significant management attention and financial resources. We are subject to a number of risks customary for international operations, including:

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

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

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

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

In order to achieve our objectives, we may need to hire additional qualified software, administrative, operational, sales and technical support personnel. The process of attracting, training and successfully integrating qualified personnel into our operations can be lengthy and expensive. We may not be able to compete effectively for the personnel we need. Our future success depends on our ability to absorb and retain senior employees and to attract, motivate and retain highly qualified professional employees. We expect to recruit most of our software and systems personnel in Israel. In addition, our operations are dependent on the efforts of certain key management. Any loss of members of senior management or key technical personnel, or any failure to attract or retain highly qualified employees as needed, could materially adversely affect our business.

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

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

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

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

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

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

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

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

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

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

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

Some of the products and services we provide involve key aspects of customers information systems. These systems are frequently critical to our customers operations. As a result, our customers have a greater sensitivity to failures in these systems than do customers of other software products generally. We have never been the subject of a material damages claim related to our products and services. However, if a customer s system fails during or following the provision of products or services by us, or if we fail to provide customers with proper support for our software products, we are exposed to the risk of a claim for substantial damages being filed against us, regardless of our responsibility for the failure. When possible, we limit our liability under our product and service contracts. We cannot guarantee that these limitations of liability, if any, would be sufficient to protect us against legal claims. We maintain general liability and professional liability insurance coverage. However, we cannot assure you that our insurance coverage will be sufficient to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. If we lose one or more, large claims against us that exceed available insurance coverage, our business, operating results and financial condition may be materially adversely affected. In addition, the filing of legal claims against us in connection with contract liability may cause us negative publicity and damage to our reputation.

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

Substantial litigation over intellectual property rights exists in the software industry. We expect that software products may be increasingly subject to third-party infringement claims as the functionality of products in different industry segments overlaps. Although our products and services have never been the subject of an infringement proceeding, we cannot predict whether third parties will assert claims of infringement against us. In addition, our employees and contractors have access to software licensed by us from third parties. A breach of the non-disclosure undertakings by any of our employees or contractors may lead to a claim of infringement against us. Any claims, with or without merit, could:

- be expensive and time-consuming to defend;
- divert management s attention and resources; or
- require us to enter into royalty or licensing agreements to obtain the right to use a necessary product or component.

Royalty or licensing agreements, if required, may not be available on acceptable terms, if at all. A successful claim of product infringement against us and our failure or inability to license the infringed or similar technology could have a material adverse effect on our business, financial condition and results of operations.

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

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

Our largest shareholder, FIMGold LP, controls a significant portion of our ordinary shares and influences the outcome of matters that require shareholder approval.

Following a private placement consummated by Formula in March 2005, and the sale by Dan Goldstein of his entire shareholdings in Formula to FIMGold Limited Partnership, referred to as FIMGold LP, FIMGold LP owns approximately 33.3% of our outstanding ordinary shares. FIMGold LP is owned in equal shares by Dan Goldstein, our chief executive officer and chairman of the board, and FIMI Opportunity Fund, L.P. and parties related to it, jointly referred to as FIMI Opportunity Fund. FIMI Opportunity Fund. is managed by a company in which our directors, Ishay Davidi and Yarom Oren serve as officers. As a result, FIMGold LP is able to influence significantly the outcome of those matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This share ownership may have the effect of delaying or preventing a change in control. In addition, potential conflicts of interest may arise in the event that we enter into agreements or transactions with Dan Goldstein, his brother Gad Goldstein, our president and a member of our board, or our directors, Ishay Davidi or Yarom Oren. Although Israeli law imposes certain procedures (including shareholder approval) for approval of certain related party transactions, we cannot assure you that these procedures will eliminate the possible detrimental effects of these conflicts of interest. If certain transactions are not approved in accordance with required procedures under applicable Israeli law, these transactions may be void or voidable. See Item 7.B. Related Party Transactions.

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

The stock market in general has experienced during recent years extreme price and volume fluctuations. The market prices of securities of technology companies have been extremely volatile, and have experienced fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market fluctuations could adversely affect the market price of our ordinary shares and American Depositary Shares, or ADSs. During 2004, for example, the market price of our ADSs fluctuated between $13.44 and $21.80, and in 2005, the market price of our ADSs fluctuated between $9.92 and $20.44. The market price of the ordinary shares and the ADSs may fluctuate substantially due to a variety of factors, including:

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

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

public announcements concerning us or our competitors;

results of integrating investments and acquisitions;

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

changes in product pricing policies by us or our competitors;

changes in security analysts financial estimates;

changes in accounting principles;

sales of our shares by existing shareholders; and

the loss of any of our key personnel.

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

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

A significant portion of our assets is comprised of equity securities of publicly and non-publicly traded companies. Our publicly traded subsidiaries are BluePhoenix Solutions Ltd. (formerly known as Crystal Systems Solutions Ltd.), Magic Software Enterprises Ltd., Matrix IT Ltd., Sapiens International Corporation N.V. and Formula Vision Technologies (F.V.T.) Ltd. The stock prices of these publicly traded companies have been extremely volatile, and have experienced fluctuations due to market conditions and other factors which are beyond our control. On June 5, 2006, Sapiens was been notified by the NASDAQ National Market that it fails to comply with the minimum shareholders equity requirement for continued listing on the NASDAQ. In connection therewith, Sapiens has been requested to submit a specific plan to achieve and sustain compliance with NASDAQ listing requirements. We cannot assure you that Sapiens will be able to maintain its listing on NASDAQ. The failure to maintain the NASDAQ listing could have a material adverse impact on the share price of Sapiens. Fluctuations in the market price and valuations of our holdings in these companies may affect the value of our assets. In addition, the stock prices of many technology companies fluctuate significantly for reasons that may be unrelated to operating results. If the value of our assets decreases significantly as a result of the above, our business, operating results and financial condition, may be materially and adversely affected.

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

As of June 20, 2006, we had 13,200,000 ordinary shares outstanding, of which 442,529 were represented by ADSs. Of the 13,200,000 shares outstanding, 4,731, 521 shares are held by affiliates. If a large number of our ordinary shares held by affiliates are sold in a short period, the price of our ordinary shares would likely decrease.

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

Although we do not believe that we were a passive foreign investment company, or PFIC, for U.S. federal income tax purposes during 2005, we cannot assure you that we will not be treated as a passive foreign investment company in 2006 or in future years. We would be a passive foreign investment company if 75% or more of our gross income in a taxable year is passive income. We would also be a passive foreign investment company if at least 50% of our assets in a taxable year produce, or are held for the production of, passive income. Passive income includes interest, dividends, royalties, rents and annuities. If we are or become a passive foreign investment company, many of you will be subject to adverse tax consequences, including having gain realized on the sale of our ordinary shares or ADSs being treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges apply to such sale proceeds. A decline in the value of our ordinary shares or ADSs may result in our being a PFIC. United States shareholders should consult with their own tax advisors with respect to the United States tax consequences of investing in our ordinary shares.

For a discussion of how we might be characterized as a PFIC