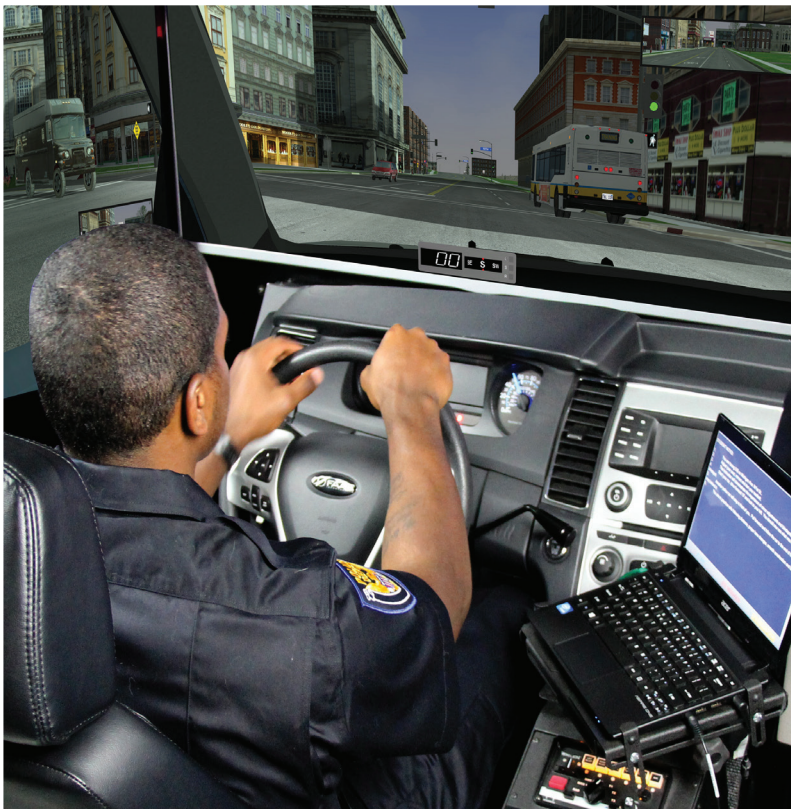




ANNUAL REPORT 2018

AROTECH CORPORATION
NASDAQ ARTX

AROTECH



**BE POWERED. BE TRAINED.
BE SAFE – WITH AROTECH**



**Arotech creates quality
defense and security
products for the military,
law enforcement and
homeland security markets.**

AROTECH

Arotech Corporation

Annual Report 2018

Nasdaq: ARTX

ARTOTECH

March 2019

Dear Fellow Shareholder,

Thank you for your support of Arotech. 2018 was a challenging year for the company that brought modest earnings improvement over the previous year. We generated meaningful growth in our Training and Simulation Division, while our Power Systems Division encountered revenue challenges both expected and unexpected during the year. In the midst of these challenges, we were diligent in constraining our costs while still advancing the strategic priorities which we believe will support future growth.

We are excited for the coming year, which will bring opportunities that could significantly augment our businesses. Our strategic investments the last two years in hybrid power solutions at our U.S. power subsidiary have put us in a strong position to capture production contracts for the next evolution of expeditionary power solutions for the U.S. Marines. In addition, our decades long leadership position in wheeled vehicle operator trainers will similarly give us a good opportunity to capture upcoming simulation based training contracts with the U.S. Army.

Our team is encouraged by the progress that we've made introducing new battery products in the commercial and medical marketplaces. We believe these products will continue to form an increasingly important economic base for our Power Systems Division as we look to expand beyond our historical market concentrations with new products that are sold internationally. It is likewise rewarding to witness the new sales heights being reached in our air warfare weapon simulation product area and our use of force training simulators, MILO Range.

I look forward to working with the capable employees of our Training and Simulation and Power Systems Divisions in 2019 as we continue to innovate and create new products designed to differentiate us from our competitors and deliver the returns that our investors expect.

Sincerely,



Dean M. Krutty
President and Chief Executive Officer

The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on March 7, 2019.

Safe Harbor Statement. *This annual report contains historical information and forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to our business, financial condition and results of operations. The words “estimate,” “project,” “intend,” “expect” and similar expressions are intended to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward-looking statements. Further, we operate in an industry sector where securities values may be volatile and may be influenced by economic and other factors beyond our control. In the context of the forward-looking information provided in this annual report and in other reports, please refer to the discussions of risk factors detailed in, as well as the other information contained in, our other filings with the Securities and Exchange Commission.*

General

We are a defense and security company engaged in two business areas: interactive simulation and mobile power systems.

➤ We develop, manufacture and market advanced high-tech multimedia and interactive simulation solutions for engineering research, enhanced weapon employment, use-of-force training and operator training of military, law enforcement, security, emergency services and other personnel through our **Training and Simulation Division**:

- We provide interactive operator and crew training systems featuring state-of-the-art vehicle simulator technology enabling training and research in situation awareness, risk analysis and decision-making, emergency reaction and avoidance procedures, conscientious equipment operation, and crew coordination;
- We provide aircrew decision making support software, part-task aircraft simulators, and simulated weapon models to support military operations and aircrew training to the United States and foreign militaries;
- Under the trade name MILO Range™, we provide specialized “use-of-force” and judgment skills training systems for police, security personnel and the military to train their personnel in safe, productive, and realistic environments; and
- Under the trade name Realtime Technologies™ (“Realtime”), we provide consulting and development support for engineering and research simulation solutions.

➤ We provide advanced battery solutions, innovative energy management and power distribution technologies and world-class product design and manufacturing services for the aerospace, defense, law enforcement, and homeland security markets, and we manufacture and sell primary and rechargeable batteries, for defense and security products and medical and industrial applications through our **Power Systems Division**:

- We provide high-end electronics engineering and design services, system integration services, rapid prototyping, and vertically-integrated production services for military, aerospace, and industrial customers, including: (i) hybrid power generation systems, (ii) smart power subsystems for military vehicles and dismounted applications, and (iii) aircraft and missile systems support for cutting-edge weapons and communications technologies;
- We develop and sell rechargeable and primary batteries and smart chargers to the military and medical markets and to private defense industry in the Americas, Middle East, Europe and Asia under our Epsilon nameplate;
- We develop, manufacture and market primary batteries, rechargeable batteries and battery chargers for the military, focusing on soldier system applications that demand high energy and light weight batteries with intelligent power management and distribution; and
- We produce water-activated lifejacket lights for commercial aviation and marine applications under our Electric Fuel® nameplate.

Background

We were incorporated in Delaware in 1990 under the name “Electric Fuel Corporation,” and we changed our name to “Arotech Corporation” on September 17, 2003. We operate through our various subsidiaries (all of which are 100% owned by us):

- FAAC Incorporated (“FAAC”), a Michigan corporation located in Ann Arbor, Michigan (Training and Simulation Division);
- Epsilon-Electric Fuel Ltd. (“Epsilon-EFL”), an Israeli corporation with facilities located in Beit Shemesh, Israel (between Jerusalem and Tel-Aviv) and Dimona, Israel (in Israel’s Negev desert area) (Power Systems Division);
- UEC Electronics, LLC (“UEC”), a South Carolina limited liability company located in Hanahan, South Carolina (Power Systems Division); and

- Electric Fuel Battery Corporation (“EFB”), a Delaware corporation located in Hanahan, South Carolina (Power Systems Division).

Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and its subsidiaries.

Facilities

Our principal executive offices are located at 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our current reports on Form 8-K and our periodic reports on Form 10-Q and Form 10-K, including any amendments thereto, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the SEC in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at <http://ir.arotech.com/all-sec-filings>, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this annual report.

The offices and facilities of our Power Systems Division are located in Hanahan, South Carolina, and in Israel (in Beit Shemesh and Dimona, both of which are within Israel's pre-1967 borders). Our executive operations are conducted primarily from our principal executive offices in Ann Arbor, Michigan, which is the headquarters of our Training and Simulation Division. The Training and Simulation Division also maintains an office in Oviedo, Florida.

Training and Simulation Division

Our Training and Simulation Division develops, manufactures and markets an extensive array of trainers and simulation based solutions that provide interactive and situational awareness and training for military, law enforcement, commercial, and research customers. Our simulators safely and economically train people, from transit bus/rail operators to public safety personnel to military convoy crews, to respond immediately and appropriately in threatening and dangerous situations while under extreme pressure. Our solutions provide pilots of U.S. fighter aircraft accurate weapon employment information. We provide tools and simulation solutions used in leading edge vehicular research. During 2018,

2017, and 2016, revenues from our Training and Simulation Division were approximately \$56.7 million, \$50.3 million, and \$46.4 million, respectively.

The Training and Simulation Division concentrates on three different product areas:

- Our *Vehicle Simulation* group provides high fidelity vehicle simulators for use in operator/crew training and research applications for military, municipal, and commercial customers;
- Our *Air Warfare Simulations* group provides weapon simulations used to train military pilots, weapon employment information used in the effective use of air launched weapons, and part-task simulators to train aircrew; and
- Our *Use of Force* group provides training products focused on developing judgment skills necessary for the proper employment of various lethal and non-lethal options for municipal public safety and military personnel.

Vehicle Simulation

We provide simulators, systems engineering support and software products focused on training vehicle operators and crews for cars, trucks, and military vehicles. We provide these products to the United States military, government, municipalities, and private industry. Our fully interactive driver-training systems feature state-of-the-art vehicle simulator technology enabling training in situation awareness, risk analysis and decision making, emergency reaction and avoidance procedures, and proper equipment operation techniques. We also offer simulation software applications, consulting services, and custom software and hardware development services primarily for use by the automobile industry and universities engaged in the study of vehicle performance or operator/vehicle interactions. Our simulators have been used to train hundreds of thousands of drivers.

Our Vehicle Simulation group focuses on the development and delivery of complete simulation solutions for a wide range of vehicle types and applications— such as trucks, automobiles, subway trains, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles and encompasses both driver training and full crew coordination training. We are the prime contractor for the U.S. Army's Virtual Clearance

Training Suite (“VCTS”) program. VCTS trains route clearance teams on techniques to detect and neutralize improvised explosive devices. In 2018, 2017, and 2016, our Vehicle Simulations group accounted for approximately 38%, 27%, and 37%, respectively, of our Training and Simulation Division’s revenues. In 2018, 2017, and 2016, our Vehicle Simulations group accounted for 22%, 14%, and 18%, respectively, of our consolidated revenues.

We believe that we have held a dominant market share in U.S. military wheeled vehicle operator driver training simulators since 1999 and that we are currently one of three significant participants in the U.S. municipal wheeled vehicle simulators market.

Air Warfare Simulations

In the area of Air Warfare Simulations, we believe we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare systems for all branches of the U.S. Department of Defense (“DoD”) and its related industrial contractors. Our simulations are found in systems ranging from instrumented air combat and maneuver training ranges (such as Top Gun), full task training devices such as the F-18 Weapon Tactics Trainer, and in the on-board computer of many fighter jet aircraft. We supply on-board software to support weapon launch decisions for the F-15, F-16, F-18, F-22 and F-35 aircraft. Two of our key Air Warfare Simulations program areas are the Zone Acquisition Program (ZAP™) and our Combat Training System (CTS) weapon simulation solution. ZAP™ provides aircrew with weapon employment information using highly accurate high-speed weapon simulations embedded in the operational flight programs of all US fighter aircraft. CTS provides validated weapon simulations for use on combat training ranges and third party aircraft simulators. In 2018, 2017, and 2016, our Air Warfare Simulations group accounted for 30%, 38%, and 35%, respectively, of our Training and Simulation Division’s revenues. In 2018, 2017, and 2016, the Air Warfare Simulations group accounted for 17%, 19%, and 18%, respectively, of our consolidated revenues.

Use-of-Force

We are a leading provider of interactive, multimedia, fully digital use-of-force training simulators for law enforcement, security, military and similar applications. With a large customer base spread over twenty countries around the

world, we are a leader in the supply of simulation training products to law enforcement, governmental, and commercial clients. We conduct our interactive training activities and market our interactive training products, such as the MILO Range™ (interactive Use-of-Force and firearms training), the MILO Theater™ (an immersive training environment enabling trainees to experience up to 300 degrees of field of regard), and the MILO Response™ (judgment skills training for EMS personnel), using our MILO Range™ trade name. In 2018, 2017, and 2016, our Use-of-Force group accounted for 26%, 28%, and 20%, respectively, of our Training and Simulation Division’s revenues. In 2018, 2017, and 2016, the Use-of-Force group accounted for 15%, 14%, and 10%, respectively, of our consolidated revenues.

Warranty

We typically offer a one to two year warranty for most of our products. Additionally, we sell extended warranties to our existing customers. In 2018, 2017, and 2016, warranty revenue accounted for 6%, 6%, and 8%, respectively, of our Training and Simulation Division’s revenues.

Marketing and Customers

We market our Training and Simulation Division products to all branches of the U.S. military, international militaries, federal and local governments, municipal transportation departments, research institutions, private organizations, and public safety groups. Municipalities throughout the U.S. and Mexico are using our vehicle simulators and use-of-force products, and our penetration in Asia, Europe and the Americas continues through the use of commissioned sales agents, regional distributors, and strategic corporate partnerships.

We have long-term relationships, many of over twenty years’ duration, with the U.S. Air Force, U.S. Navy, U.S. Army, U.S. Marine Corps, Department of Homeland Security, and most major U.S. Department of Defense training and simulation prime contractors and related subcontractors. The quality of our customer relationships is illustrated by the multiple program contract awards we have earned from many of our customers.

We also have long term relationships with original equipment manufacturers such as Boeing and Raytheon that result in continued business opportunities.

Competition

Our technical excellence, superior product reliability, high customer satisfaction and warranty services have enabled us to develop market leadership and attractive competitive positions in each of our product areas.

VEHICLE SIMULATORS

Several potential competitors in this segment are large, diversified defense and aerospace conglomerates, such as L-3 Technologies, Inc. (NYSE: LLL) and Leidos Holdings, Inc. (NYSE: LDOS), who do not focus exclusively on our specific niches. As such, we are able to compete directly with these organizations based on our strength in developing higher quality software solutions or provide service on certain large military contracts through strategic agreements with these organizations. In municipal market applications, we compete against smaller, less sophisticated companies, such as Raydon Corporation and Doron Precision Systems, Inc., and some startups that rely on a commercial gaming engine as a training solution. Many of our large business competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

AIR WARFARE SIMULATIONS

Currently, we believe that no significant competitors participate in the markets we serve around our weapon simulation niche. Our over 45-year history in this space provides us with a library of resources that would require substantial investment by a competitor to offer a comparable product. The companies that have the potential to compete with us are companies that now subcontract this work to us: Boeing Company (NYSE: BA) ("Boeing"), Raytheon Company (NYSE: RTN) ("Raytheon"), and Lockheed Martin Corporation (NYSE: LMT).

USE OF FORCE

We compete against a number of established companies that provide similar products and services, some of which have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours. There are also companies whose products do not compete directly, but are sometimes closely related to the products we offer. Cubic Corporation (NYSE: CUB), Meggitt PLC (LSE: MGT), VirTra, Inc. (Nasdaq: VTSI), Ti Training Corp., and Laser Shot, Inc. are our main competitors in this space.

Power Systems Division

Our Power Systems Division develops and provides sophisticated portable power solutions for diverse applications, including military equipment carried by soldiers, hybrid energy generation/storage in austere environments, power management and power distribution, and clean, stable power for tactical vehicles, unmanned vehicles and medical devices, all of which are designed to complex and demanding customer specifications. During 2018, 2017, and 2016, revenues from our Power Systems Division were approximately \$39.9 million, \$48.5 million, and \$46.6 million, respectively.

Electronics Engineering and Design Services for the Military

INTRODUCTION

We design, engineer, and manufacture proprietary electronics, spanning components and sub-assemblies, for a broad range of end use systems in multiple markets that include aerospace, defense, industrial and medical. We specialize in electronic/electromechanical systems, subsystems, and component level requirements, which include circuit card assemblies and wire and cable assemblies. Our products range from complex integrated assemblies up through multi-track functional systems and test equipment.

In addition, we also specialize in core, proprietary engineering capabilities in highly-demanded solution areas, including: (i) hybrid power generation systems, (ii) smart power subsystems for military vehicles and dismounted applications, and (iii) aircraft and missile systems support for cutting-edge weapons and communications technologies. Our unique brand of comprehensive service is highly sought-after by customer agencies such as the Marine Corps Systems Command, Space and Naval Warfare Systems Command ("SPAWAR"), U.S. Army Communications and Electronics Research & Development Command ("CERDEC") and Tank Automotive Command, as well as large prime contractors such as Raytheon, Science Applications International Corporation (NYSE: SAIC) ("SAIC"), Boeing, Lockheed Martin Corporation (NYSE: LMT), and BAE Systems plc (LON: BA) ("BAE"). Our key program areas in this field include the following:

- We supply the United States Marine Corps ("USMC") with its program of record Ground Renewable Expeditionary Energy Network Systems ("GREENS"), a renewa-

ble power generation, intelligent energy storage and distribution system for troops serving in austere environments. GREENS is the only DoD Program of Record for renewable power generation. We also offer a commercial (not ITAR-restricted) version of this product, targeting both domestic and international markets where clean, reliable power in austere, rugged environments is a critical need.

- We have supplied the USMC with Mobile Hybrid Expeditionary Energy System ("MHEES"), a product that incorporates both solar collection and high density battery technologies to intelligently reduce run time and optimize efficiency of tactical generators. This single system is scalable to 3.5kW, 7kW and 10.5kW output, making it an ideal solution for multiple military missions. During 2017, we delivered to the Marine Corps Systems Command the next-generation of MHEES, known as Mobile Electric Hybrid Power Sources ("MEHPS"). MEHPS is a modular, scalable system capable of delivering clean, reliable three-phase power in a 5kW dismounted configuration as well as a 10kW trailer mounted configuration. UEC supported government testing in 2018.
- We designed a proprietary Distributed Power Control and Management System (DPCMS) that could replace electrical systems on aging tactical vehicles such as the Light Armored Vehicle (LAV) and Amphibious Assault Vehicle (AAV). This power management and distribution system enables vehicles that have already exceeded the OEM's recommended life to be refurbished and to take advantage of new automotive communication protocol J-1939. These refurbishments could permit aging tactical vehicle fleets to function as a new vehicle, without the cost implications of replacing it with a new vehicle. This system was successfully tested on LAVs and AAVs by the USMC. DPCMS is also being marketed to newer vehicle systems that can benefit from its modular design and combat survivability features.
- We have developed significant expertise and past performance qualifications in the area of solutions for Command, Control, Communications, Computers Intelligence, Surveillance and Reconnaissance

(C4ISR), providing these solutions to, among others, SPAWAR and Raytheon.

COMPETITION

Our main competitors for renewable energy and power management systems and services are ZeroBase Energy, LLC, a provider of hybrid and renewable power systems, and Solar Stik, Inc., a provider of portable and custom power solutions. In the realm of contract design and manufacturing services, we compete with Sechan Electronics Inc., a provider of military electronic systems and subsystems, IEC Electronics Corporation (NYSE: IEC), a provider of electronic contract manufacturing services, Celestica Incorporated (NYSE: CLS), Ducommun Incorporated (NYSE: DCO), Sanmina Corporation (Nasdaq: SANM), and Jabil Incorporated (NYSE: JBL), a supplier of manufacturing services for circuit board assemblies.

We believe the fact that we have full-service engineering coupled with state-of-the-art manufacturing provides us with an advantage over most of our competitors, enabling us to customize solutions for customers, quickly develop prototype and first-article units, and move into full-rate production before many of our competitors are beyond the requirements definition phase. We believe few in the industry have both the agility and capabilities required to offer this advantage. As a manufacturer, we build our own cable harnesses, circuit cards, and integrated complex assemblies, which enables us to control our own supply chain and program schedules. These combined capabilities have resulted in lower costs and shorter lead times, both very important discriminators for our customers in this current fiscal environment.

MARKETING AND CUSTOMERS

We market to a diverse array of customers. The renewable and hybrid energy market prior to 2015 had been primarily focused on the U.S. Department of Defense. We believe we have achieved significant success in this market; however, we are modifying our products to better meet commercial/industrial demands. In addition, we are refocusing marketing efforts internationally on the heels of our GREENS and MHEES programs. Specific efforts include exhibiting at international trade shows like DSEI and Eurosatory, establishing international sales channels, establishing networks within U.S. commercial markets, and an increase in outbound marketing efforts designed to drive potential customers to our solutions.

Over 90% of revenues are attributed to existing customers with new requirements or referrals of new customers from our existing customer base. This customer loyalty is closely tied to our technical solutions, our on-time delivery and quality of product metrics (consistently 90% or greater).

MANUFACTURING

Our three AS9100 and ISO 9001 registered facilities are located in the tri-county area of Charleston, South Carolina. All facilities are well equipped with state of the art design tools and automated manufacturing equipment to support our customers' design, testing, and production needs.

Lithium Batteries and Charging Systems for Military, Industrial, and Medical Markets

We sell lithium batteries and charging systems, including the SWIPES™ power hubs that we produce for the Army's Soldier Warrior program, to the military, industrial and medical markets.

We develop and produce high-end lithium batteries, both primary (disposable) and secondary (rechargeable), "smart" chargers for the rechargeable batteries, electronic sub-assemblies and back up batteries for a range of "Smart City" applications (such as cellular switches and security towers). Battery offerings include a growing line of standard products (such as the BB-2590, ELI-152, 6T NATO, and 12V/24V lead-acid replacement batteries) as well as high-end custom products.

We market to the military, medical and industrial markets. We believe we are among the few companies in the world with the capability to develop, manufacture and test complex portable power sources needed by high-end portable applications. We perform the development and manufacturing in-house with the exception of the electrochemical cells, which we purchase from suppliers. We have also begun to penetrate the "special" batteries market, meaning large format batteries (such as those used to power submarines) and high power batteries (such as those used in missile launchers and battle tank emergency startup units).

We have experience in working with government agencies, the military and large corporations. Our technical team has significant expertise in the fields of electrochemistry, electronics, software and battery design, production, packaging and testing. We also specialize

in custom products that must meet the highest possible military, industrial and medical specifications.

Our SWIPES™ power hub utilizes the MOLLE (Modular Lightweight Load-carrying Equipment) vest and integrates force protection electronics and communications equipment with an advanced battery. The system utilizes a modular power distribution system that is powered by a conformal wearable battery allowing for extended mission times without the burden of power source swaps or charging due to the conformal battery's high energy density. It also reduces the battery weight soldiers carry by up to 30%. The batteries continuously charge the secondary batteries inside various devices, such as two way radios, GPS units and shot detection systems.

CUSTOMERS

The principal customers for our lithium batteries during 2018 were the Israel Ministry of Defense, Elbit Systems Ltd. (Nasdaq: ESLT), Israel Aerospace Industries Ltd. (TASE: ARSP), and Rafael Advanced Defense Systems Ltd. The principal customer for our soldier power systems in 2018 was the U.S. Defense Logistics Agency, with interest also shown from the U.K. Ministry of Defence and the Polish Territorial Defence Force.

COMPETITION

There are a limited number of players globally that are a one-stop-shop for high-end custom portable power. Our main competitors are Bren-Tronics, Inc., Ultralife Corporation (Nasdaq: ULBI) ("Ultralife"), Inventus Power, Protonex Technology Corporation, Saft America Inc., Electrochem Solutions, Inc., RRC Power Solutions and Inspired Energy Plc (LSE: INSE).

MANUFACTURING

Our U.S. manufacturing facility for batteries and chargers is located in Hanahan, South Carolina, in the Charleston area. In parallel, we have manufacturing facilities in Beit Shemesh and Dimona, both located in Israel.

Lifejacket Lights

We are a world leader in the supply of water-activated lifejacket and survivor locator lights to the marine and aviation markets. Since 1996 we have offered a range of safety products used by the marine and aerospace industries, commercial airlines and military outfitters. Our life-jacket lights are certified by air and marine regu-

latory organizations, and are available through distributors worldwide.

PRODUCTS

We have a product line consisting of six life-jacket light models. Five of these models are for use with marine lifejackets and one is for use with aviation lifejackets. The marine lifejacket lights come in two LED alkaline-powered models (a one-piece and a two-piece model), two LED lithium-powered models (a one-piece product and a two-piece product), and a two-piece lithium-powered incandescent mode. Our new aviation locator light is based on LED powered by our proprietary battery chemistry. All of our life-jacket lights work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations, including the U.S. Federal Aviation Administration's Technical Standard Order ("TSO"), the EU's Marine Equipment Directive 2014/90/EU (MED), and the International Safety of Life at Sea (SOLAS) Convention. We manufacture, assemble and package all our lifejacket lights in our factory in Beit Shemesh, Israel.

MARKETING

We market our marine safety products through our own network of distributors in Europe, the United States, Asia and Oceania. We market our lights to the commercial aviation industry through an independent company.

COMPETITION

Our primary competitor in the field of aviation safety products, including TSO-approved lifejacket lights, is ACR Electronics Inc. of Ft. Lauderdale, Florida. Other significant competitors in the marine market include Daniamant A/S of Denmark and England, a provider of survivor location lights, and Alcares ApS of Denmark, a manufacturer of marine emergency lights.

Backlog

We generally sell our products under standard purchase orders. Orders constituting our backlog are subject to changes in delivery schedules and are typically cancelable by our customers until a specified time prior to the scheduled delivery date. Accordingly, our backlog is not necessarily an accurate indication of future sales. As of December 31, 2018, 2017, and 2016, our funded backlog was approximately \$64.8 million, \$61.1 million, and \$55.4 million, respectively, divided between our divisions as follows:

Division	2018	2017	2016
Training and Simulation Division .	\$47,291,000	\$38,752,000	\$18,790,000
Power Systems Division.....	17,554,000	22,349,000	36,584,000
TOTAL:	<u>\$64,845,000</u>	<u>\$61,101,000</u>	<u>\$55,374,000</u>

Major Customers

During 2018, 2017, and 2016, including both of our divisions, various branches of the United States military accounted for approximately 35%, 33%, and 41%, respectively, of our revenues.

Patents and Trade Secrets

We rely on certain proprietary technology and seek to protect our interests through a combination of patents, trademarks, copyrights, know-how, trade secrets and security measures, including confidentiality agreements. Our policy generally is to secure protection for significant innovations to the fullest extent practicable. Further, we seek to expand and improve the technological base and individual features of our products through ongoing research and development programs.

Our intellectual property portfolio includes five issued U.S. patents, which expire between 2019 and 2037. We also have various patent applications pending for examination in U.S. and foreign jurisdictions.

We rely on the laws of unfair competition and trade secrets to protect our proprietary rights. We attempt to protect our trade secrets and other proprietary information through confidentiality and non-disclosure agreements with customers, suppliers, employees and consultants, and through other security measures. However, we may be unable to detect the unauthorized use of, or take appropriate steps to enforce our intellectual property rights. Effective trade secret protection may not be available in every country in which we offer or intend to offer our products and services to the same extent as in the United States. Failure to adequately protect our intellectual property could harm or even destroy our brands and impair our ability to compete effectively. Further, enforcing our intellectual property rights could result in the expenditure of significant financial and managerial resources and may not prove successful. Although we intend to protect our rights vigorously, there can be no assurance that these measures will be successful.

Research and Development

During the years ended December 31, 2018, 2017, and 2016, our research and product de-

velopment expenses were approximately \$3.0 million, \$3.0 million, and \$2.7 million, respectively. Not included in these figures are any research and development where the costs were underwritten by customers or charged directly to projects as non-recovered engineering costs.

Employees

As of December 31, 2018, we employed 472 total employees worldwide, substantially all of whom were full-time employees. Our success will depend in large part on our ability to attract and retain skilled and experienced employees.

With respect to those of our employees who are Israeli residents, Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without due cause. We currently partially fund our ongoing severance obligations by making monthly payments to approved severance funds or insurance policies.

Raw Materials

We are dependent on the availability of raw materials from our suppliers. The most important raw materials are lithium cells and zinc for our batteries. We purchase these raw materials from various suppliers. We believe alternative sources generally exist for the raw materials used for our batteries.

Regulatory Matters

Our businesses are heavily regulated in most of our markets. We deal with numerous U.S. government agencies and entities, including, but not limited to, branches of the U.S. military and the Department of Homeland Security. Similar government authorities exist in our international markets. We are also subject to export regulations.

Government Contracts

The U.S. government, and other governments, may terminate any of our government contracts at their convenience, as well as for default, based on our failure to meet specified performance requirements. If any of our U.S. government contracts were to be terminated for convenience, we generally would be entitled to receive payment for work completed and allowable termination or cancellation costs. If any of our government contracts were to be terminated for default, generally the U.S. government would pay only for the work that has been accepted and can require us to pay the difference be-

tween the original contract price and the cost to re-procure the contract items, net of the work accepted from the original contract. The U.S. government can also hold us liable for damages resulting from the default.

On October 3, 2018, our U.S. Power Systems Division subsidiary was informed by its customer, Science Applications International Corporation ("SAIC"), that the United States Marines Corps terminated for its convenience its efforts to modernize the Assault Amphibious Vehicle fleet that was undergoing survivability and electrical upgrades under a prime contract with SAIC. As a result of this termination for the USMC's convenience, we presented our costs related to this program for reimbursement by SAIC and the USMC in December 2018. The amount of reimbursement and time frame for resolution have not yet been determined.

Environmental

We are subject to various federal, state, local and non-U.S. laws and regulations relating to environmental protection, including the discharge, treatment, storage, disposal and remediation of hazardous substances and wastes. We continually assess our compliance status and management of environmental matters to ensure our operations are in substantial compliance with all applicable environmental laws and regulations. Investigation, remediation, operation and maintenance costs associated with environmental compliance and management of sites are a normal, recurring part of our operations. These costs often are allowable costs under our contracts with the U.S. government. It is reasonably possible that continued environmental compliance could have a material impact on our results of operations, financial condition or cash flows if additional work requirements or more stringent clean-up standards are imposed by regulators, new areas of soil and groundwater contamination are discovered and/or expansions of work scope are prompted by the results of investigations.

Market for Our Securities

Our common stock is traded on the Nasdaq Global Market. Our Nasdaq ticker symbol is "ARTX." As of February 28, 2019, we had approximately 127 registered holders of record of our common stock.

Dividends

We have never paid any cash dividends on our common stock. The Board of Directors pres-

ently intends to retain all earnings for use in our business. Any future determination as to payment of dividends will depend upon our financial condition and results of operations and such

other factors as the Board of Directors deems relevant. Additionally, our ability to declare dividends should we decide to do so is restricted by the terms of our debt agreements.

SELECTED FINANCIAL DATA

The selected financial information set forth below with respect to the consolidated statements of operations for each of the five fiscal years ended December 31, 2018, and with respect to the consolidated balance sheets at the end of each such fiscal year, has been derived from our consolidated financial statements audited by BDO USA, LLP, independent registered public accounting firm.

The financial information set forth below is qualified by and should be read in conjunction with the Consolidated Financial Statements contained in this Annual Report and the notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations," below.

Income (loss) from continuing operations and the related per basic and dilute share amounts for 2017 have been restated due to the correction of an error related to income tax accounting. See discussion at Note 3, "Restatement of Previously Issued Consolidated Financial Statements," of the Notes to Consolidated Financial Statements contained in this Annual Report and "Management's Discussion and Analysis of Financial Condition and Results of Operation" titled "Accounting for Income Taxes."

	Year Ended December 31,				
	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
	(dollars in thousands, except per share data)				
Statement of Operations:					
Revenues	\$ 96,600	\$ 98,723	\$ 92,975	\$ 96,574	\$ 103,562
Cost of revenues	\$ 67,402	\$ 71,083	\$ 64,825	\$ 68,457	\$ 70,855
Research and development expenses	\$ 3,031	\$ 3,041	\$ 2,723	\$ 3,075	\$ 2,926
Selling and marketing expenses	\$ 8,176	\$ 7,874	\$ 7,029	\$ 5,373	\$ 5,921
General and administrative expenses	\$ 12,919	\$ 11,624	\$ 15,308	\$ 16,339	\$ 17,261
Amortization of intangible assets	\$ 1,677	\$ 2,206	\$ 2,876	\$ 3,044	\$ 2,697
Total operating costs and expenses	\$ 93,205	\$ 95,828	\$ 92,761	\$ 96,288	\$ 99,660
Operating income	\$ 3,395	\$ 2,895	\$ 214	\$ 286	\$ 3,902
Other income (expense)	\$ (39)	\$ (8)	\$ 65	\$ (24)	\$ 2,512
Financial expense, net.....	\$ (922)	\$ (1,077)	\$ (975)	\$ (1,152)	\$ (1,507)
Total other income (expense)	\$ (961)	\$ (1,085)	\$ (910)	\$ (1,176)	\$ 1,005
Income (loss) before income tax.....	\$ 2,434	\$ 1,810	\$ (696)	\$ (890)	\$ 4,907
Income tax (benefit) expense	\$ 564	\$ (5,225)	\$ 784	\$ 1,161	\$ 1,024
Income (loss) from continuing operations.....	\$ 1,870	\$ 7,035	\$ (1,480)	\$ (2,051)	\$ 3,883
Basic net income (loss) per share – continuing operations ..	\$ 0.07	\$ 0.27	\$ (0.06)	\$ (0.08)	\$ 0.18
Diluted net income (loss) per share– continuing operations.	\$ 0.07	\$ 0.27	\$ (0.06)	\$ (0.08)	\$ 0.17
Weighted average number of shares used in computing basic net income (loss) per share	26,471,507	26,380,312	25,494,097	23,687,733	21,934,532
Weighted average number of shares used in computing diluted net income (loss) per share	26,471,507	26,380,312	25,494,097	23,687,733	22,537,272
As At December 31,					
	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
	(dollars in thousands)				
Balance Sheet Data:					
Cash, cash equivalents, and restricted collateral deposits ...	\$ 4,445	\$ 5,489	\$ 7,400	\$ 10,698	\$ 11,528
Receivables and other assets.....	\$ 54,001	\$ 50,289	\$ 43,782	\$ 45,612	\$ 49,485
Property and equipment, net of depreciation	\$ 8,914	\$ 9,276	\$ 5,915	\$ 6,385	\$ 6,463
Goodwill and other intangible assets, net	\$ 50,604	\$ 51,344	\$ 52,313	\$ 54,798	\$ 57,263
Total assets	\$ 117,964	\$ 116,398	\$ 109,410	\$ 117,493	\$ 124,739
Current liabilities	\$ 27,701	\$ 26,319	\$ 23,761	\$ 26,777	\$ 28,117
Long-term liabilities.....	\$ 13,487	\$ 15,785	\$ 20,564	\$ 26,669	\$ 30,267
Stockholders' equity	\$ 76,776	\$ 74,294	\$ 65,085	\$ 64,047	\$ 66,355
Total liabilities and stockholders' equity.....	\$ 117,964	\$ 116,398	\$ 109,410	\$ 117,493	\$ 124,739

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve inherent risks and uncertainties. When used in this discussion, the words "believes," "anticipates," "expects," "estimates" and similar expressions are intended to identify such forward-looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors including, but not limited to, those set forth elsewhere in this report. This should be read in conjunction with the Consolidated Financial Statements contained in this report below, and the notes thereto, as well as the "Risk Factors" section in our filings with the Securities and Exchange Commission.. See also "Cautionary Statement Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995," above, and our other filings with the Securities and Exchange Commission.

We have restated our financial statements for the year ended December 31, 2017 due to the identification of an error in accounting for income taxes related to the treatment of a naked tax credit as a source of income against non-net operating loss deferred tax assets. As a result we did not record a reversal of our valuation allowance associated with these deferred tax assets within the enactment period. We concluded that we should restate our consolidated financial statements for 2017. Our Management's Discussion and Analysis of Financial Condition and Results of Operations set forth below provides a discussion of and reflects the effects of the restatement. See details at Note 3, "Restatement of Previously Issued Consolidated Financial Statements," of the Notes to Consolidated Financial Statements contained in this report below.

We have rounded amounts reported here to the nearest thousand, unless such amounts are more than \$1.0 million, in which event we have rounded such amounts to the nearest hundred thousand.

General

We are a defense and security company engaged in two business areas: interactive simulation, and batteries and charging systems.

- We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for engineering, use-of-force training and operator training of military, law enforcement, security, emergency services and other personnel through our **Training and Simulation Division**.
- We provide advanced battery solutions, innovative energy management and power distribution technologies and world-class product design and manufacturing services for the aerospace, defense, law enforcement and homeland security markets, and we manufacture and sell primary rechargeable batteries, for defense and security products and medical and industrial applications through our **Power Systems Division**.

Recent Developments

On October 3, 2018, our U.S. Power Systems Division subsidiary was informed by its customer,

Science Applications International Corporation ("SAIC"), that the United States Marine Corps ("USMC") had discontinued its efforts to upgrade the Assault Amphibious Vehicle ("AAV") fleet that was undergoing survivability and electrical upgrades under a prime contract with SAIC. As a result of this termination for the USMC's convenience, we presented our costs related to this program for reimbursement by SAIC and the USMC in December 2018. The amount of reimbursement and time frame for resolution have not yet been determined.

Federal Income Tax

Our deferred income tax benefit and net deferred income tax liabilities have been restated as of and for the year ended December 31, 2017 due to the correction of errors related to the treatment of a naked tax credit as a source of income against non-net operating loss ("NOL") U.S. federal deferred tax assets. As a result, we did not record a reversal of our valuation allowance associated with these deferred tax assets within the period of enactment, resulting in us concluding that the previously issued 2017 consolidated financial statements were misstated. Accordingly, we have restated our 2017 consolidated financial

statements to reflect the impact of releasing a portion of the previously reported valuation allowance associated with the expected reversal of these U.S. federal non-NOL deferred tax assets. This resulted in an increase in the deferred income tax benefit for 2017 by \$3.2 million with a corresponding increase to net income and earnings per share. See details in Note 3, "Restatement of Previously Issued Consolidated Financial Statements," of the Notes to Consolidated Financial Statements contained in this report below.

The U.S. Tax Cuts and Jobs Act ("Tax Act") was enacted on December 22, 2017. The Tax Act makes broad complex changes to the U.S. tax code including, but not limited to, reduction of the U.S. federal corporate tax rate from 35% to 21%, requiring reversing U.S. federal non-NOL deferred tax assets to convert to an NOL carryforward with an indefinite carryforward period, requiring companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, creating new taxes on certain foreign sourced earnings and additional limitations on the deductibility of interest.

The SEC issued Staff Accounting Bulletin No. 118 (SAB 118) in December 2017 to provide guidance on accounting for the effects of the Tax Act. SAB 118 provides for a measurement period of up to one year from the Tax Act enactment date for companies to complete their assessment of and accounting for those effects of the Tax Act. Under SAB 118, a company must first reflect the income tax effects of the Tax Act for which the accounting is complete in the period of the date of enactment. To the extent the accounting for other income tax effects is incomplete, but a reasonable estimate can be determined, companies must record a provisional estimate to be included in their financial statements. The measurement period ended during the fourth quarter of 2018 and we completed our accounting for the effects of the Tax Act and did not make material adjustments to the amounts recorded in 2018. However, we did adjust for the restatement for the income tax accounting errors in 2017 as referenced above.

In 2017 (as restated), we recorded tax benefits related to the enactment-date effects of the Tax Act that included adjusting deferred tax assets and liabilities for the change in tax rates and recognizing the effects of releasing our valuation allowance associated with U.S. federal non-NOL deferred tax assets expected to reverse in the future by utilizing indefinite lived U.S. federal deferred tax liabilities as a source of future taxable

income of \$3.2 million and \$3.2 million, respectively. We had no liabilities associated with the one-time transition tax related to our foreign subsidiary due to the accumulated net loss position of the subsidiary.

Beginning in 2018, the Tax Act provided a 100% deduction for dividends received from 10-percent owned foreign corporations by U.S. corporate shareholders, subject to a one-year holding period. Although dividend income is now exempt from U.S. federal tax in the hands of the U.S. corporate shareholders, companies must still apply the guidance of ASC 740-30-25-18 to account for the tax consequences of outside basis differences and other tax impacts of their investments in non-U.S. subsidiaries. While we did not accrue the transition tax on the deemed repatriated earnings that were previously indefinitely reinvested, we were unable to determine a reasonable estimate as of December 31, 2017 of the remaining tax liability, if any, under the Tax Act for its remaining outside basis. Upon completion of our analysis throughout 2018, we determined that the recording of a deferred tax liability on the outside basis difference of our foreign subsidiary was not required as of December 31, 2018 due to the existence of accumulated losses. It is our assertion that we will permanently reinvest any future earnings from our foreign subsidiary back into its operations.

The Tax Act limits NOL deductions to 80% of taxable income for tax years beginning after December 31, 2017. The amendments disallow the carryback of NOLs but allow for the indefinite carryforward of NOLs, which would be considered an indefinite lived asset.

Discontinued Operations

During the quarter ended September 30, 2016, our Board of Directors approved a plan to discontinue the Flow Battery segment. The discontinuance was a strategic shift that had a major effect on our operations and financial results; therefore, the results of the Flow Battery segment were reclassified as discontinued operations as of and for the period ended December 31, 2016.

Our financial results are presented as continuing operations in the Consolidated Financial Statements for all periods presented. See Note 1, "General," of the Notes to Consolidated Financial Statements. The loss from discontinued operations reported for the year ended December 31, 2016 was \$1.4 million. The impact of the discontinued operations on operating activities and on investing activities within the consolidated state-

ment of cash flows for the year ended December 31, 2016 was \$(1.3 million) and \$(252,000), respectively.

During the quarter ended December 31, 2017, it was determined that we were not able to execute our plan to sell the assets associated with the Flow Battery segment. As a result, assets in the amount of \$270,000 were reclassified on the consolidated balance sheet into property and equipment, which are being used in our operations and therefore are not considered to be impaired as of December 31, 2018.

Critical Accounting Policies

The preparation of financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates and judgments, including those related to revenue recognition, allowance for bad debts, taxes, inventory, purchase price allocation, contingencies and deferred warranty revenue, impairment of intangible assets and goodwill. We base our estimates and judgments on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Under different assumptions or conditions, actual results may differ from these estimates.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We account for revenue recognition in accordance with Accounting Standards Codification ("ASC") 606, Revenue from Contracts with Customers, which we adopted on January 1, 2018, using the modified retrospective method. We evaluated the distinct performance obligations and the pattern of revenue recognition of our significant contracts upon adoption of the standard. Consequently, after our review of contracts in each revenue stream, we concluded that the impact of adopting the standard did not have an impact to our consolidated balance sheets, statements of operations, changes in stockholders' equity, or cash flows.

During 2018, 2017, and 2016, we recognized revenues from (i) the sale and customization of interactive training systems (Training and Simulation Division); (ii) maintenance services in connection with such systems (Training and Simulation Division); (iii) the sale of batteries, chargers and adapters, and custom power solutions (Power Systems Division); and (iv) the sale of lifejacket lights (Power Systems Division).

We determined our revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations within the contract
- Determination of the transaction price
- Allocation of the transaction price to the performance obligations within the contract
- Recognition of revenue when, or as the performance obligation has been satisfied

Accounting for Income Taxes

Significant judgment is required in determining our worldwide income tax expense provision. In the ordinary course of a global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities, the process of identifying items of revenue and expense that qualify for preferential tax treatment and segregation of foreign and domestic income. Although we believe that our estimates are reasonable, the final tax outcome of these matters may be different than that which is reflected in our historical income tax provisions and accruals.

The Tax Act was enacted on December 22, 2017. The Tax Act makes broad complex changes to the U.S. tax code including, but not limited to, reduction of the U.S. federal corporate tax rate from 35% to 21%, requiring reversing U.S. federal non-NOL deferred tax assets to convert to an NOL carryforward with an indefinite carryforward period, requiring companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, creating new taxes on certain foreign sourced earnings and additional limitations on the deductibility of interest. The Tax Act is complex and requires interpretation of certain provi-

sions to estimate the impact on our income tax expense. The estimates are based on the information available and our current interpretation of the Tax Act, and may change due to changes in interpretations and assumptions we make and additional guidance or context from the Internal Revenue Service, the U.S. Treasury Department, the Financial Accounting Standards Board or others regarding the Tax Act. Our accounting for the impacts of the Tax Act is provisional and our actual income tax benefit could differ from our estimates. Please refer to Note 13, "Financial Expense," of the Notes to Consolidated Financial Statements for additional information.

We have provided a valuation allowance on our net deferred income tax assets, which includes federal, state and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under FASB ASC 740-10, involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We provided a valuation allowance for our deferred tax assets resulting principally from the carryforward of NOLs. At December 31, 2017, based upon provisions of the Tax Act, we reduced the valuation allowance by \$3.2 million after consideration of U.S. deferred tax assets reversing into indefinite-lived NOLs, which can now be applied against taxable temporary differences related to indefinite-lived intangible assets as a future source of taxable income. Management currently believes that it is more likely than not that except for the differences related to these indefinite-lived intangible assets, our deferred tax assets in the U.S. and Israel will not be realized in the foreseeable future, but as our results improve, this may change in future periods. We were not required to record any amounts for our foreign subsidiaries relating to the one-time tax on accumulated foreign earnings provision of the Tax Act due to the accumulated net loss position of the foreign subsidiary.

We have indefinite-lived intangible assets consisting of trademarks and goodwill. Pursuant to FASB ASC 350-10, these indefinite-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred in-

come tax expense and a U.S. federal deferred tax liability arise as a result of the tax-deductibility of these indefinite-lived intangible assets. The resulting U.S. federal deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a "naked tax credit." This U.S. federal deferred tax liability could remain on our balance sheet indefinitely for continuing operations unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of. Due to the fact that the aforementioned deferred tax liability could have an indefinite life, these deferred tax liabilities are now being utilized as a future source of taxable income against U.S. federal non-NOL deferred tax assets that will convert into net operating losses with an unlimited carryforward period, as allowed by the Tax Act.

Accounting standards prescribe a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. We must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. Uncertain tax positions require determinations of estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If our determinations and estimates prove to be inaccurate, the resulting adjustments could be material to our future financial statements.

In addition, we operate within multiple taxing jurisdictions and may be subject to audits in these jurisdictions. These audits can involve complex issues that may require an extended period of time for resolution. In management's opinion, adequate provisions for income taxes have been made.

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which

includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the net realizable value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-downs if actual market conditions are less favorable than those projected by our management. If the inventory reserve increased by 10%, the impact would not be material to the consolidated financial statements. For fiscal 2018, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill and Indefinite-Life Intangibles

Certain business acquisitions have resulted in the recording of goodwill and indefinite-life intangible assets, primarily trademark assets, which are not amortized. We had goodwill of \$46.1 million and trademark assets with a carrying value of \$799,000 for the periods ended December 31, 2018 and 2017.

Goodwill is tested for impairment at the reporting unit level, which is the operating segment or one level below the operating segment, also known as a component. Two or more components of an operating segment shall be aggregated into a single reporting unit if the components have similar economic characteristics, based on an assessment of various factors. We have determined that the Training and Simulation Division and the Power System Division segments are reporting units.

We have historically performed our annual goodwill impairment test as of December 31 each year. During the quarter ended September 30, 2018, we voluntarily changed our annual impairment assessment date from December 31 to October 1. We believe this change in measurement date, which represents a change in method of applying an accounting principle, is preferable under the circumstances as it better aligns with our forecasting and annual budgeting process timeline. As we assess qualitative factors that

may give rise to triggering events quarterly, we did not consider the change in date of our annual impairment test material to our financial statements.

We conduct a qualitative assessment by analyzing a variety of factors that could influence the fair value of the reporting unit or indefinite-life intangible, including, but not limited to: the results of prior quantitative assessments performed; changes in the carrying amount of the reporting unit or indefinite-life intangible; actual and projected revenue and operating margin; relevant market data for both us and our peer companies; industry outlooks; macroeconomic conditions; liquidity; changes in key personnel; and our competitive position. We use significant judgment to evaluate the totality of these events and factors to make the determination of whether it is more likely than not that the fair value of the reporting unit or indefinite-life intangible is less than its carrying value.

If we determine that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, we perform the impairment evaluation using the quantitative assessment. Under the quantitative assessment, the first step identifies whether there is a potential impairment by comparing the fair value of our reporting unit to the carrying amount, including goodwill. If the carrying amount of our reporting unit exceeds the fair value, then a test is performed to determine the implied fair value of goodwill. An impairment loss is recognized based on the amount that the carrying amount of goodwill exceeds the implied fair value. When measuring the fair value of its reporting units in the quantitative assessment, we use widely accepted valuation techniques, applying a combination of the income approach (discounted cash flows) and market approach (market multiples). When preparing discounted cash flow models under the income approach, we use internal forecasts to estimate future cash flows expected to be generated by the reporting units. To discount these cash flows, we use the expected cost of equity, determined by using a capital asset pricing model. We believe the discount rates used appropriately reflect the risks and uncertainties in the financial markets generally and specifically in our internally-developed forecasts. When using market multiples under the market approach, we apply comparable publicly traded companies' multiples (for example, earnings or revenues) to our reporting units' actual results.

The determination of fair value is highly sensitive to differences between estimated and actual cash flows and changes in the related discount rate used to evaluate fair value. Estimated cash flows are sensitive to changes in the economy among other things. If the carrying value of the intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. Furthermore, if the cash flows from the Power Systems reporting unit were lower by 10%, then the fair value of the reporting unit would approximate the carrying value of the reporting unit.

However, estimates are inherently uncertain and represent only management's reasonable expectations regarding future developments. These estimates and the judgments and assumptions upon which the estimates are based will, in all likelihood, differ in some respects from actual future results. Should a significant or prolonged deterioration in economic conditions occur, such as declines in government spending; the inability to pass increases in the costs of raw materials on to customers; or a decline in comparable company market multiples, then key judgments and assumptions could be impacted.

For the years ended December 31, 2018 and 2017, respectively, we performed a qualitative assessment for our Training and Simulation reporting unit and we determined that it was more likely than not that the fair value of our reporting unit exceeded its carrying value. For our Power Systems reporting unit, we performed a quantitative assessment of goodwill for the purpose of determining whether an impairment existed at December 31, 2018 and 2017. As a result of our quantitative analysis, in which we computed the fair value of the Power Systems reporting unit, we concluded that the fair value of the reporting unit exceeded the reporting unit's carrying value by approximately 10% and 22%, respectively. If we had changed the discount rate by 50 basis points the fair value of the reporting unit would have decreased by approximately 5.0%.

As a result of this analysis, we concluded that the goodwill recorded in relation to the Power Systems reporting unit was not impaired at October 1, 2018.

Other Intangible Assets

Other intangible assets are amortized over the period during which benefits are ex-

pected to accrue, currently estimated at one to ten years.

The determination of the value of such intangible assets requires us to make assumptions regarding future business conditions and operating results in order to estimate future cash flows and other factors to determine the fair value of the respective assets. If these estimates or the related assumptions change in the future, we could be required to record additional impairment charges.

Impairment analysis triggering events include a significant decrease in the market price of a long-lived asset, a significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition, a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, a current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of the long lived asset, and a current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

Functional Currency

The United States dollar ("U.S. dollar") is the currency of the primary economic environment in which our U.S. subsidiaries operate and we have adopted and are using the U.S. dollar as our functional currency. Transactions and balances originally denominated in U.S. dollars are presented at the original amounts. Accordingly, monetary accounts maintained in currencies other than dollars are re-measured into dollars, with resulting gains and losses reflected in our consolidated statements of operations and comprehensive income as financial income or expenses, as appropriate.

In the first quarter of 2018, we concluded that the functional currency for our Israeli subsidiary, Epsilor-EFL, had changed from the New Israeli Shekel ("NIS") to the U.S. dollar. The primary reason for the change in functional currencies is due to a change in our operations whereby the majority of our contracts and our material costs is now anticipated to be sourced in U.S. dollars. We believe that the change in functional currency for this business was necessary as it reflects the primary economic environment in which Epsilor-EFL operates.

The financial statements of Epsilor-EFL are reported in U.S. dollars. All balance sheet accounts were translated using the exchange rates in effect at the time of the change in functional currency. Certain of Epsilor-EFL's subsidiaries continue to operate under the NIS functional currency. Correspondingly, translation gains and losses are reported in our statement of operations and comprehensive income and cash flows. The statements of operations and comprehensive income and cash flows are also reported in U.S. dollars.

New Accounting Standards

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. In addition, in July 2018, the FASB issued ASU No. 2018-10, *Codification Improvement to Topic 842*.

In July 2018, the FASB issued ASU No. 2018-11, *Targeted Improvements to Topic 842*. This amendment provides the Company with an additional and optional transition method to adopt the new leases standard. Under this new transition method, the Company can apply the new lease standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption and present the accounting on a prospective or go-forward basis instead of applying to the earliest comparative period presented in the financial statements. The standard will be effective for the Company beginning January 1, 2019.

The Company has elected to apply the new transition method upon adoption of the new standard. The Company also elected the available practical expedients on adoption. In preparation for adoption of the standard, the Company finalized changes to systems, implemented internal controls and key processes to enable the preparation of financial information.

Results of Operations

SUMMARY

Following is a table summarizing our results of continuing operations for the years ended December 31, 2018, 2017 and 2016, after which we present a narrative discussion and analysis.

The new standard will likely have a material impact on the Company's Consolidated Balance Sheets. However, is not expected to have a material impact to the Company's Consolidated Statements of Operations and Comprehensive Income, and Consolidated Statement of Cash Flows. The most significant impact will be the recognition of ROU assets and lease liabilities for operating leases and will result in additional ROU assets and lease liabilities for operating leases of approximately \$3.9 million and \$4.0 million, respectively, as of January 1, 2019.

In August 2016, the FASB issued ASU No. 2016-15 (Topic 230), *Classification of Certain Cash Receipts and Cash Payments*. The amendments provide guidance on eight specific cash flow issues for which the current accounting framework does not provide specific guidance. The amendments are effective for annual periods beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The Company adopted the requirements of the new standard in the first quarter of 2018, as required by the new standard.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230), Restricted Cash*, which requires that restricted cash be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The provisions of ASU 2016-18 are effective for years beginning after December 15, 2017, with early adoption permitted. The Company adopted the requirements of the new standard in the first quarter of 2018 using the retrospective transition method, as required by the new standard. The adoption of this ASU had an immaterial impact to our consolidated statements of cash flows.

For information on recently issued but not yet adopted accounting pronouncements, see Note 2, "Significant Accounting Policies," of the Notes to Consolidated Financial Statements contained within this annual report.

	Year Ended December 31,		
	2018	2017 (as restated)	2016
Revenues:			
Training and Simulation Division	\$ 56,708,170	\$ 50,254,324	\$ 46,358,794
Power Systems Division	39,891,571	48,468,354	46,616,958
	<u>\$ 96,599,741</u>	<u>\$ 98,722,678</u>	<u>\$ 92,975,752</u>
Cost of revenues:			
Training and Simulation Division	\$ 33,235,613	\$ 29,223,721	\$ 26,193,216
Power Systems Division	34,166,650	41,858,987	38,632,200
	<u>\$ 67,402,263</u>	<u>\$ 71,082,708</u>	<u>\$ 64,825,416</u>
Research and development expenses:			
Training and Simulation Division	\$ 1,706,606	\$ 2,544,164	\$ 2,030,485
Power Systems Division	1,323,863	496,966	692,480
	<u>\$ 3,030,469</u>	<u>\$ 3,041,130</u>	<u>\$ 2,722,965</u>
Selling and marketing expenses:			
Training and Simulation Division	\$ 6,440,536	\$ 6,204,037	\$ 5,517,682
Power Systems Division	1,734,967	1,670,327	1,511,408
	<u>\$ 8,175,503</u>	<u>\$ 7,874,364</u>	<u>\$ 7,029,090</u>
General and administrative expenses:			
Training and Simulation Division	\$ 4,444,119	\$ 4,235,512	\$ 4,556,990
Power Systems Division	4,342,723	3,847,728	4,011,769
Corporate	4,132,595	3,540,660	6,739,702
	<u>\$ 12,919,437</u>	<u>\$ 11,623,900</u>	<u>\$ 15,308,461</u>
Amortization of intangible assets:			
Training and Simulation Division	\$ 410,693	\$ 397,880	\$ 461,168
Power Systems Division	1,266,750	1,807,875	2,414,375
	<u>\$ 1,677,443</u>	<u>\$ 2,205,755</u>	<u>\$ 2,875,543</u>
Operating income (loss):			
Training and Simulation Division	\$ 10,470,603	\$ 7,649,010	\$ 7,599,253
Power Systems Division	(2,943,382)	(1,213,529)	(645,274)
Corporate	(4,132,595)	(3,540,660)	(6,739,702)
	<u>\$ 3,394,626</u>	<u>\$ 2,894,821</u>	<u>\$ 214,277</u>
Other income (loss):			
Training and Simulation Division	\$ 6,340	\$ (2,293)	\$ 9,430
Power Systems Division	(45,417)	(5,620)	47,673
Corporate	—	(243)	7,729
	<u>\$ (39,077)</u>	<u>\$ (8,156)</u>	<u>\$ 64,832</u>
Financial (expense) income:			
Training and Simulation Division	\$ (256,452)	\$ (122,875)	\$ (41,397)
Power Systems Division	22,638	(255,835)	(87,371)
Corporate	(688,139)	(697,949)	(846,495)
	<u>\$ (921,953)</u>	<u>\$ (1,076,659)</u>	<u>\$ (975,263)</u>
Income tax (benefit) expense:			
Training and Simulation Division	\$ 292,599	\$ 41,391	\$ (24,634)
Power Systems Division	(211,080)	195,592	(28,507)
Corporate	482,122	(5,461,858)	836,561
	<u>\$ 563,641</u>	<u>\$ (5,224,875)</u>	<u>\$ 783,420</u>
Net income (loss) – continuing operations:			
Training and Simulation Division	\$ 9,927,892	\$ 7,482,451	\$ 7,591,920
Power Systems Division	(2,755,081)	(1,670,576)	(656,465)
Corporate	(5,302,856)	1,223,006	(8,415,029)
	<u>\$ 1,869,955</u>	<u>\$ 7,034,881</u>	<u>\$ (1,479,574)</u>

Fiscal Year 2018 compared to Fiscal Year 2017 (as restated)

Revenues. We recognized revenues as follows:

➤ **Training and Simulation Division** – We recognized revenues from the sale of air warfare simulators and vehicle simulators, interactive use-of-force training systems and from the provision of maintenance services in connection with such systems.

➤ **Power Systems Division** – We recognized revenues from sales of electronics engineering products and provision of design services for the military, as well as from the sale of batteries, chargers, adapters and power hub products to the military and commercial customers. We also recognized revenues from the sale of water-activated battery (“WAB”) lifejacket lights.

Revenues for 2018 totaled \$96.6 million, compared to \$98.7 million in 2017, a decrease of \$(2.1) million, or (2.2)%, due primarily to higher revenues in our Training and Simulation Division offset by lower revenues in our Power Systems Division. In 2018, revenues were \$56.7 million for the Training and Simulation Division as compared to \$50.2 million in 2017, an increase of \$6.5 million, or 12.8%, primarily due to increased sales of interactive use-of-force training systems related to new sales to the U.S. Air Force and increased sales of our Vehicle Simulation products; and \$39.9 million for the Power Systems Division as compared to \$48.5 million in 2017, a decrease of \$(8.6) million, or (17.7)%, due primarily to a reduction in manufacturing of certain batteries in our Israeli operations for the Israeli Ministry of Defense and a decrease in revenues in our U.S. subsidiary related to terminations and delays on key customer programs. In late August, the government issued a stop work order on the AAV program, which ultimately led to the termination for the government's convenience of the AAV program on October 3, 2018.

The table below details the percentage of total recognized revenue by type of arrangement for the years ended December 31, 2018 and 2017:

Type of Revenue	Year Ended December 31,	
	2018	2017
Sale of products	94.3%	96.2%
Maintenance and support agreements	3.7%	3.2%
Long term research and development contracts	2.0%	0.6%
Total	100.0%	100.0%

Cost of revenues. Cost of revenues totaled \$67.4 million during 2018, compared to \$71.1 million in 2017, a decrease of \$(3.7) million, or (5.2)%, due primarily to a decrease in revenues. Cost of revenues were \$33.2 million for the Training and Simulation Division as compared to \$29.2 million in 2017, an increase of \$4.0 million, or 13.7%, due primarily to higher costs associated with increased sales for interactive use-of-

force training systems related to new sales to the U.S. Air Force and increased sales of our Vehicle Simulation products, and \$34.2 million for the Power Systems Division as compared to \$41.9 million in 2017, a decrease of \$(7.7) million, or (18.4)%, due primarily to reduction in manufacturing of certain batteries in our Israeli operations and a decrease in revenues in our U.S. subsidiary related to terminations and delays on key customer programs.

Research and development expenses. Research and development expenses were \$3.0 million for 2018 and 2017.

Selling and marketing expenses. Selling and marketing expenses for 2018 were \$8.2 million, compared to \$7.8 million in 2017, an increase of \$301,000, or 3.8%, due primarily to increased selling and marketing efforts in our Training and Simulation Division.

General and administrative expenses. General and administrative expenses for 2018 were \$12.9 million, compared to \$11.6 million in 2017, an increase of \$1.3 million or 11.1%. The increase is primarily due to increased investment in the Israeli operations, non-income based taxes, a temporary increase in professional service fees, and incentive based compensation.

Amortization of intangible assets. Amortization of intangible assets totaled \$1.7 million in 2018, compared to \$2.2 million in 2017, a decrease of \$(528,000), or (24.0)%, due primarily to higher amortization expense recognized in 2017 pertaining to shorter lived intangible assets.

Other expense, net. Other expense totaled \$(39,000) in 2018, compared to expense of \$(8,000) in 2017, an increase in expense of \$(31,000).

Financial expense, net. Financial expense totaled \$(922,000) in 2018, compared to financial expense of \$(1.1) million in 2017, a decrease of \$155,000, or (14.4)%, primarily due to a net decrease in foreign exchange losses offset by an increase in interest expense related to Term Loan C, due to the inception of the new mortgage in June 2017.

Income taxes. We recorded tax expense of \$564,000 in 2018, compared to a \$(5.2) million tax benefit in 2017 (as restated), an increase in tax expense of \$5.8 million, or 110.8%. The primary reasons for the increase in income tax expense are attributable to tax benefits arising in

2017 related to the release of our valuation allowance associated with realizability of our non-NOL deferred tax assets, and the change in the federal corporate income tax rate from 35% to 21% attributable to the Tax Act.

Net income (loss). Due to the factors cited above, we went from a net income of \$7.0 million in 2017 (as restated) to net income of \$1.9 million in 2018.

Fiscal Year 2017 (as restated) compared to Fiscal Year 2016

Revenues. We recognized revenues as follows:

- **Training and Simulation Division** – We recognized revenues from the sale of air warfare simulators and vehicle simulators, interactive use-of-force training systems and from the provision of maintenance services in connection with such systems.
- **Power Systems Division** – We recognized revenues from sales of electronics engineering products and provision of design services for the military, as well as from the sale of batteries, chargers, adapters and power hub products to the military and commercial customers. We also recognized revenues from the sale of water-activated battery (“WAB”) lifejacket lights.

Revenues for 2017 totaled \$98.7 million, compared to \$93.0 million in 2016, an increase of \$5.7 million, or 6.2%, due primarily to higher revenues in both our divisions. In 2017, revenues were \$50.2 million for the Training and Simulation Division as compared to \$46.4 million in 2016, an increase of \$3.8 million, or 8.2%, due primarily to significant revenue growth in all product lines offset by a decline in revenues associated with the wind-down of the first phase of our VCTS program in preparation for the ramp up of the second phase of our VCTS program; and \$48.5 million for the Power Systems Division as compared to \$46.6 million in 2016, an increase of \$1.9 million, or 4.1%, due primarily to increases in key programs in Israel of \$4.1 million offset by a decline in revenues at UEC of \$2.2 million primarily attributable to the timing of contract awards and the receipt of material used in production of key programs.

The table below details the percentage of total recognized revenue by type of arrangement for the years ended December 31, 2017 and 2016:

Type of Revenue	Year Ended December 31,	
	2017	2016
Sale of products	96.2%	95.3%
Maintenance and support agreements.....	3.2%	4.3%
Long term research and development contracts	0.6%	0.4%
Total	100.0%	100.0%

Cost of revenues. Cost of revenues totaled \$71.1 million during 2017, compared to \$64.8 million in 2016, an increase of \$6.3 million, or 9.7%, due primarily to higher costs associated with higher revenues in both our divisions. Cost of revenues were \$29.2 million for the Training and Simulation Division as compared to \$26.2 million in 2016, an increase of \$3.0 million, or 11.5%, due primarily to higher costs associated with increased revenues, and \$41.9 million for the Power Systems Division as compared to \$38.6 million in 2016, an increase of \$3.3 million or 8.5%, due primarily to higher costs associated with increased revenues.

Research and development expenses. Research and development expenses for 2017 were \$3.0 million, compared to \$2.7 million during 2016, an increase of \$318,000, or 11.7%, due primarily to increased development activities in our Vehicle Simulation product area offset by a decrease in research and development expense as key personnel were assigned to project-related development activities in our U.S. operations of our Power Systems Division.

Selling and marketing expenses. Selling and marketing expenses for 2017 were \$7.8 million, compared to \$7.0 million in 2016, an increase of \$845,000, or 12.0%, due primarily to increased selling and marketing efforts in our Vehicle Simulation product area as well as increased efforts in our use-of-force product areas.

General and administrative expenses. General and administrative expenses for 2017 were \$11.6 million, compared to \$15.3 million in 2016, a decrease of \$(3.7) million or (24.1)%. The decrease is primarily due to \$1.4 million in lower salaries and benefits, \$1.0 million non-recurring severance resulting from the 2016 separation of our former Chairman and Chief Executive Officer as well as a reduction in our stock compensation expense in the amount of \$480,000.

Amortization of intangible assets. Amortization of intangible assets totaled \$2.2 million in 2017, compared to \$2.9 million in 2016, a de-

crease of \$(670,000), or (23.3)%, due primarily to higher amortization expense recognized in 2016 pertaining to shorter lived intangible assets.

Other income (expense), net. Other expense totaled \$(8,000) in 2017, compared to income of \$65,000 in 2016, an increase in expense of \$(73,000).

Financial expense, net. Financial expense totaled \$(1.1) million in 2017, compared to financial expense of \$(1.0) million in 2016, an increase of \$(101,000), or 10.4%, due primarily to foreign exchange transactions.

Income taxes. We recorded a \$(5.2) million tax benefit in 2017 (as restated), compared to \$783,000 in tax expense in 2016, a decrease in tax expense of \$(6.0) million, or (766.9)%. The primary causes for the decrease in income tax expense pertain to the restatement associated with the release of our valuation allowance and the re-measurement of our deferred tax liabilities associated with the change in the federal corporate income tax rate from 35% to 21% attributable to the Tax Act.

Net income (loss). Due to the factors cited above, we went from a net loss from continuing operations of \$(1.5) million in 2016 to a net income of \$7.0 million in 2017 (as restated).

Liquidity and Capital Resources

As of December 31, 2018, we had \$4.2 million in cash and \$223,000 in restricted collateral deposits, as compared to December 31, 2017, when we had \$5.2 million in cash and \$284,000 in restricted collateral deposits. We also had \$8.2 million in available, unused bank lines of credit as of December 31, 2018, under a \$15.0 million debt credit facility.

We used available funds in 2018 primarily for working capital needs, investment in fixed assets and repayment of long-term debt. Our net property and equipment amounted to \$8.9 million of December 31, 2018.

Net cash provided by operating activities for 2018, 2017, and 2016 was \$3.3 million, \$1.9 million, and \$2.6 million, respectively. The increase of \$1.4 million in cash provided by operating activities for 2018 as compared to 2017 was primarily attributable to improved operating results of \$793,000 and a reduction of non-recurring severance of \$1.6 million offset by an increase in working capital of \$(990,000) primarily attributable to maintaining higher receivable balances

associated with the resolution of the termination of the AAV contract with SAIC.

Net cash used in investing activities for 2018, 2017, and 2016 was \$(2.6) million, \$(5.4) million, and \$(1.9) million, an increase between 2018 and 2017 of \$2.8 million and a decrease between 2017 and 2016 of \$(3.5) million. The net change in cash used in investing activities for 2018 as compared to 2017 was due primarily to the non-recurring nature of a \$2.1 million building purchase in 2017 and \$700,000 related to the implementation of an enterprise resource planning system within our Israel Power Systems business unit.

Net cash provided by (used in) financing activities for 2018, 2017, and 2016 was \$(1.9) million, \$2.4 million, and \$(3.8) million, respectively, a change between 2018 and 2017 of \$(4.3) million and between 2017 and 2016 of \$6.2 million. The decrease in 2018 of cash used in financing activities was primarily due to proceeds in 2017 associated with Term Loans B and C of \$(2.2) million, a change in the utilization of our line of credit of \$(1.7) million, and payments on our long-term debt of \$(410,000).

As of December 31, 2018, our line-of-credit and long-term bank debt, including current maturities, was \$5.5 million and \$8.6 million as compared to December 31, 2017, when we had \$5.1 million outstanding on our line of credit and \$10.8 million in long-term debt outstanding, including current maturities.

We maintain credit facilities with JPMorgan Chase Bank, N.A. ("Chase"), whereby Chase provides (i) a \$15,000,000 revolving credit facility ("Revolver"), (ii) a \$10,000,000 Term Loan ("Term Loan A"), (iii) a \$1,730,895 Mortgage Loan ("Term Loan B") and (iv) a \$1,358,000 Mortgage Loan ("Term Loan C"); collectively referred to as the "Credit Facilities."

The maturity of the Revolver is March 11, 2021. The Revolver maintains an interest rate on a scale ranging from LIBOR plus 1.75% up to LIBOR plus 3.00%. The effective interest rate for the revolver at December 31, 2018 was 5.50%.

The maturity of Term Loan A is March 11, 2021. This Term Loan maintains an interest rate on a scale ranging from LIBOR plus 2.0% up to LIBOR plus 3.25%. The repayment of this Term Loan consists of 60 consecutive monthly payments of principal plus accrued interest based on annual principal reductions of 10% during the first year, 20% during the second through fourth

years, and 30% during the fifth year. The effective interest rate for this Term Loan at December 31, 2018 was 5.75%.

In 2017, our Training and Simulation Division in Ann Arbor, Michigan purchased land and a building for \$2.2 million. As a result, there are two Mortgage Loans ("Mortgage Loans B and C"). The maturities of the Mortgage Loans are June 1, 2024 and maintain an interest rate on a scale identical to the Term Loan. The monthly payments on the Mortgage Loans are \$12,872 in principal plus accrued interest, with balloon payments due at the maturity date. The effective interest rate for the Mortgage Loans at December 31, 2018 was 5.75%.

The Credit Facilities maintain certain reporting requirements, conditions precedent, affirmative covenants and financial covenants. We are required to maintain certain financial covenants that include a Maximum Debt to EBITDA ratio of 3.00 to 1.00 and a Minimum Fixed Charge Coverage Ratio of 1.20 to 1.00. We were in compliance with our covenants at December 31, 2018.

The Credit Facilities are secured by our assets and the assets of our domestic subsidiaries.

Subject to all of the reservations regarding "forward-looking statements" set forth above, we believe that our present cash position, anticipated cash flows from operations and availability under our lines of credit should be sufficient to satisfy our current estimated cash requirements through the next twelve months.

Effective Corporate Tax Rate

Our effective tax rate for continuing operations for the year ended December 31, 2018, 2017 (as restated), and 2016 was 23%, (289)%,

and (113)%, respectively. Our effective tax rate for 2017 (as restated) was significantly affected by the Tax Act. Additionally, changes in the valuation allowance and the foreign tax rate differential were substantial factors in the 2017 and 2016 reconciliations of our effective tax rate to the statutory rate. In 2017 (as restated) we recorded an income tax benefit of \$6.4 million associated with the Tax Act pertaining primarily to the release of our valuation allowance associated with the realizability of our U.S. federal non-NOL deferred tax assets and re-measuring our U.S. federal deferred tax liability based upon the change in federal corporate income tax rates from 35% to 21%.

As of December 31, 2018, we had a U.S. federal net operating loss carryforward of approximately \$33.8 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2021 through 2037, and foreign net operating and loss carryforwards of approximately \$90.1 million, which are available indefinitely to offset future taxable income under certain circumstances.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to our stockholders.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2018, not including trade payables and other accounts payable:

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Bank obligations	\$14,065,638	\$ 7,705,069	\$ 3,979,634	\$ 308,928	\$ 2,072,007
Operating lease obligations	\$ 4,727,467	\$ 1,161,909	\$ 1,280,678	\$ 775,965	\$ 1,508,915
Severance obligations	\$ 4,607,728	\$ 482,053	\$ —	\$ —	\$ 4,125,675
Capital lease obligations	\$ 23,526	\$ 5,913	\$ 17,613	\$ —	\$ —

Contingencies

From time to time we are involved in legal proceedings and other claims. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. We have not made any material changes in the accounting methodology used to establish our self-insured liabilities during the past three fiscal years.

A determination of the amount of reserves required, if any, for any contingencies are made after

careful analysis of each individual issue. The required reserves may change due to future developments in each matter or changes in approach, such as a change in the settlement strategy in dealing with any contingencies, which may result in higher net loss.

If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to market risks in the ordinary course of our business. These risks include interest rate risk and, on a limited basis, price risk with respect to foreign exchange transactions. The adverse effects of changes in these markets could pose a potential loss as discussed below. The sensitivity analysis provided does not consider the effects that such adverse changes may have on overall economic activity, nor does it consider additional actions we may take to mitigate our exposure to such changes. Actual results may differ.

Interest Rate Risk. We are subject to market risk associated with changing interest rates on our variable rate long-term debt and short-term revolver; the variable interest rates are based on LIBOR. The interest rates applicable to variable rate notes and revolver may rise and increase the amount of interest expense on our variable rate long-term and short-term debt. We

do not purchase or hold any derivative instruments to protect against the effects of changes in interest rates.

As of December 31, 2018, we had \$14.0 million of variable rate debt including current maturities. A hypothetical 50 basis point change in market interest rates would have increased interest expense by approximately \$75,000 in our fiscal year ended December 31, 2018.

Foreign Currency Risk. We have foreign currency risks related to our operating expenses denominated in currencies other than the U.S. dollar, primarily the New Israeli Shekel. Our revenue is U.S. dollar denominated. To date, foreign currency transaction gains and losses have not been material to our financial statements and we have not had a formal hedging program with respect to foreign currency. A 10% increase or decrease in current exchange rates would have affected our financial results by approximately \$800,000.

CONTROLS AND PROCEDURES

Background

As previously reported in our Current Report on Form 8-K filed on March 6, 2019, on March 4, 2019, our Board of Directors, based on the recommendation of the audit committee and in consultation with management, concluded that our previously issued financial statements for the fiscal year ended December 31, 2017 should be restated in order to correct for an identified error associated with our income tax accounting. Accordingly, we have restated our previously issued financial statements for 2017. See "Management's Discussion and Analysis of Financial Condition and Results of Operation" above and Note 3, "Restatement of Previously Issued Consolidated Financial Statements," of the Notes to Consolidated Financial Statements in this report.

Evaluation of Disclosure Controls and Procedures

As of December 31, 2018, our management, including the principal executive officer and principal financial officer, conducted an evaluation of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). To ensure that information required to be disclosed in the reports we file or submit under the Exchange Act was recorded, processed, summarized, and reported as applicable, within the time periods specified in the SEC's rules and forms and to allow timely decisions regarding required disclosure.

Based on this evaluation, our principal executive officer and principal financial officer were able to con-

clude that, as of December 31, 2018, our disclosure controls and procedures were effective.

Management's Report on Internal Control Over Financial Reporting

Our management, including our principal executive and financial officers, is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Rule 13a-15(f) of the Exchange Act. The Company's internal control over financial reporting is a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of its financial reporting and the preparation of its financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Due to the inherent limitations of control systems, internal controls over financial reporting may prevent or detect misstatements. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met. 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.

Our management has evaluated the effectiveness of our internal controls over financial reporting as of the

end of the period covered by our Annual Report on Form 10-K for the year ended December 31, 2018. In making our assessment of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in the 2013 *Internal Control – Integrated Framework*.

Based upon that evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2018.

Our internal control over financial reporting as of December 31, 2018 has been audited by BDO USA, LLP, an independent registered public accounting firm, as stated in their attestation report which appears herein.

Remediation of the Material Weakness in Internal Control over Financial Reporting

As previously disclosed in our Current Report on Form 8-K filed on March 6, 2019, our management identified an error in its accounting for income taxes. This error resulted in a material weakness in our internal control over financial reporting. A material weakness is a deficiency, or combination of deficiencies, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. As a result of the U.S. Tax Cuts and Jobs Act and even before identification of the material weakness in internal control over financial reporting related to income tax accounting, we had determined that we needed to make improvements to our existing processes related to income tax accounting and began implementing the following:

- In the second quarter of fiscal 2018, we engaged third-party consultants whose area of expertise is income tax accounting to assist in the preparation of our quarterly and annual provisions as well as our annual tax returns.
- In the second quarter of fiscal 2018, our management instituted a quarterly control to meet with tax consultants and certain third-party advisor's to discuss current trends and business results, as well as to obtain a briefing from tax consultants updating management on areas or developments that may have tax implications, including significant changes in tax legislation.
- In the third quarter of fiscal 2018, our management added various controls surrounding the accuracy and review of information ex-

changed with third-party tax consultants to ensure tax calculations are calculated correctly.

- In the third quarter of fiscal 2018, our management developed a quarterly and annual income tax control matrix documenting our quarterly and annual controls over our provision and tax return processes to ensure our accounting for income taxes is accurate and addresses income tax accounting matters timely.
- Our management instituted a continuing education plan to ensure that they are aware of and understand any future changes to or developments from tax legislation changes.

During the quarter ended December 31, 2018, we were actively engaged in the testing of remedial measures noted above, designed to address our material weakness and demonstrate their operating effectiveness. During the same quarter, we completed testing of the design and operating effectiveness of new and enhanced controls. We believe these changes have improved our internal controls over financial reporting and income tax accounting enough to remediate the issues that caused the material misstatement and the restatement of our financial statements for the period ended December 31, 2017. As a result, as of December 31, 2018, we concluded that we had remediated the material weakness in our internal control over financial reporting.

We will continue to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and correct any deficiencies that we may discover in the future. Our goal is to ensure that our senior management has timely access to all material financial and non-financial information concerning our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to modify our disclosure controls and procedures.

Changes in Internal Control Over Financial Reporting

As a result of the remediation efforts noted above, there were changes in our internal control over financial reporting as described above that occurred during the fiscal quarter ended December 31, 2018 that materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors
Arotech Corporation
Ann Arbor, Michigan

Opinion on Internal Control over Financial Reporting

We have audited Arotech Corporation's (the "Company's") internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of Arotech Corporation as of December 31, 2018 and 2017, the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2018, and the related notes and our report dated March 7, 2019, expressed an unqualified opinion thereon.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying item 9A, 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 are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit of internal control over financial reporting in accordance with the standards of the PCAOB. 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, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

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.

/s/ BDO USA, LLP

Grand Rapids, Michigan
March 7, 2019

Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors
Arotech Corporation
Ann Arbor, Michigan

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Arotech Corporation (the "Company") as of December 31, 2018 and 2017, the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2018 and 2017, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and our report dated March 7, 2019 expressed an unqualified opinion thereon.

Restatement to Correct 2017 Misstatement

As discussed in Note 3 to the consolidated financial statements, the 2017 financial statements have been restated to correct a misstatement.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Company's auditor since 2006.
Grand Rapids, Michigan
March 7, 2019

AROTECH CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2018	2017 (as restated)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 4,222,246	\$ 5,205,246
Restricted collateral deposits	222,712	283,508
Trade receivables, net.....	16,259,809	19,258,960
Contract assets	17,867,896	16,094,515
Other accounts receivable and prepaid expenses	5,989,263	2,342,220
Inventories	9,912,748	8,654,878
Total current assets	54,474,674	51,839,327
LONG TERM ASSETS:		
Contractual and Israeli statutory severance pay fund	3,427,705	3,754,789
Other long term receivables	543,205	184,331
Property and equipment, net.....	8,914,247	9,276,088
Other intangible assets, net	4,465,778	5,205,605
Goodwill	46,138,036	46,138,036
Total long term assets	63,488,971	64,558,849
Total assets	\$ 117,963,645	\$ 116,398,176
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 6,442,919	\$ 5,560,196
Other accounts payable and accrued expenses	6,498,045	6,640,154
Current portion of long term debt	2,204,653	2,248,043
Short term bank credit.....	5,500,416	5,092,088
Contract liabilities	7,054,779	6,778,313
Total current liabilities	27,700,812	26,318,794
LONG TERM LIABILITIES:		
Contractual and accrued Israeli statutory severance pay	4,125,675	4,709,807
Long term portion of debt	6,360,569	8,570,524
Deferred income tax liability	2,863,098	2,399,976
Other long term liabilities.....	137,774	105,112
Total long-term liabilities	13,487,116	15,785,419
Total liabilities	41,187,928	42,104,213
Commitments and contingencies (Note 10)		
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – \$0.01 par value each; Authorized: 50,000,000 shares as of De-	264,862	263,951
Preferred shares – \$0.01 par value each; Authorized: 1,000,000 shares as of De-	–	–
Additional paid-in capital	251,551,001	250,826,873
Accumulated deficit	(176,498,057)	(178,368,012)
Notes receivable from stockholders	(908,054)	(908,054)
Accumulated other comprehensive income	2,365,965	2,479,205
Total stockholders' equity	76,775,717	74,293,963
Total liabilities and stockholders' equity	\$ 117,963,645	\$ 116,398,176

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

AROTECH CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

In U.S. dollars

	December 31,		
	2018	2017 (as restated)	2016
Revenues	\$ 96,599,741	\$ 98,722,678	\$ 92,975,752
Cost of revenues	67,402,263	71,082,708	64,825,416
Research and development expenses	3,030,469	3,041,130	2,722,965
Selling and marketing expenses	8,175,503	7,874,364	7,029,090
General and administrative expenses	12,919,437	11,623,900	15,308,461
Amortization of intangible assets	1,677,443	2,205,755	2,875,543
Total operating costs and expenses	93,205,115	95,827,857	92,761,475
Operating income	3,394,626	2,894,821	214,277
Other income (expense), net	(39,077)	(8,156)	64,832
Financial expense, net	(921,953)	(1,076,659)	(975,263)
Total other expense	(961,030)	(1,084,815)	(910,431)
Income (loss) from continuing operations before income tax (benefit) expense	2,433,596	1,810,006	(696,154)
Income tax (benefit) expense	563,641	(5,224,875)	783,420
Income (loss) from continuing operations	1,869,955	7,034,881	(1,479,574)
Loss from discontinued operations	—	—	(1,368,682)
Net income (loss)	1,869,955	7,034,881	(2,848,256)
Other comprehensive income (loss), net of \$0 income tax			
Foreign currency translation adjustment	(113,240)	1,752,606	54,925
Comprehensive income (loss)	\$ 1,756,715	\$ 8,787,487	\$ (2,793,331)
Income (loss) per share of common stock:			
Basic – continuing operations	\$ 0.07	\$ 0.27	\$ (0.06)
Basic – discontinued operations	\$ —	\$ —	\$ (0.05)
Basic net income (loss) per share	\$ 0.07	\$ 0.27	\$ (0.11)
Diluted – continuing operations	\$ 0.07	\$ 0.27	\$ (0.06)
Diluted – discontinued operations	\$ —	\$ —	\$ (0.05)
Diluted net income (loss) per share	\$ 0.07	\$ 0.27	\$ (0.11)
Weighted average number of shares used in computing basic net income (loss) per share	26,471,507	26,380,312	25,494,097
Weighted average number of shares used in computing diluted net income (loss) per share	26,471,507	26,380,312	25,494,097

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

AROTECH CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Notes receivable from stock- holders	Accumulated other comprehensive income	Total stockholders' equity
	Shares	Amount					
Balance as of January 1, 2016	24,697,335	\$ 246,973	\$ 246,591,415	\$ (182,554,637)	\$ (908,054)	\$ 671,674	\$ 64,047,371
Stock based compen- sation	—	—	878,007	—	—	—	878,007
Restricted stock issued .	310,735	3,107	(3,107)	—	—	—	—
Sales of stock, net of offering costs.....	1,500,000	15,000	2,937,999	—	—	—	2,952,999
Restricted stock units vested	56,202	562	(562)	—	—	—	—
Restricted stock forfei- tures.....	(126,038)	(1,260)	1,260	—	—	—	—
Foreign currency trans- lation adjustment.....	—	—	—	—	—	54,925	54,925
Net Loss.....	—	—	—	(2,848,256)	—	—	(2,848,256)
Balance as of December 31, 2016	26,438,234	\$ 264,382	\$ 250,405,012	\$ (185,402,893)	\$ (908,054)	\$ 726,599	\$ 65,085,046
Balance as of January 1, 2017	26,438,234	\$ 264,382	\$ 250,405,012	\$ (185,402,893)	\$ (908,054)	\$ 726,599	\$ 65,085,046
Stock based compen- sation	—	—	421,430	—	—	—	421,430
Restricted stock issued .	109,320	1,094	(1,094)	—	—	—	—
Restricted stock units vested	46,165	462	(462)	—	—	—	—
Restricted stock forfei- tures.....	(198,671)	(1,987)	1,987	—	—	—	—
Foreign currency trans- lation adjustment.....	—	—	—	—	—	1,752,606	1,752,606
Net Income (as restat- ed).....	—	—	—	7,034,881	—	—	7,034,881
Balance as of December 31, 2017 (as restated).....	26,395,048	\$ 263,951	\$ 250,826,873	\$ (178,368,012)	\$ (908,054)	\$ 2,479,205	\$ 74,293,963
Balance as of January 1, 2018	26,395,048	\$ 263,951	\$ 250,826,873	\$ (178,368,012)	\$ (908,054)	\$ 2,479,205	\$ 74,293,963
Stock based compen- sation	—	—	779,194	—	—	—	779,194
Restricted stock issued .	86,900	869	(869)	—	—	—	—
Restricted stock units vested	50,247	502	(502)	—	—	—	—
Restricted stock forfei- tures.....	(46,043)	(460)	(53,695)	—	—	—	(54,155)
Foreign currency trans- lation adjustment.....	—	—	—	—	—	(113,240)	(113,240)
Net Income.....	—	—	—	1,869,955	—	—	1,869,955
Balance as of December 31, 2018	26,486,152	\$ 264,862	\$ 251,551,001	\$ (176,498,057)	\$ (908,054)	\$ 2,365,965	\$ 76,775,717

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

AROTECH CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	2018	2017 (as restated)	2016
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ 1,869,955	\$ 7,034,881	\$ (2,848,256)
<i>Adjustments required to reconcile net income (loss) to net cash provided by operating activities:</i>			
Depreciation	1,990,577	1,835,308	1,789,041
Amortization of intangible assets	1,677,443	2,205,755	2,875,543
Stock based compensation	779,194	421,430	878,007
Loss from sale of property and equipment	47,818	5,651	8,680
Deferred tax (benefit) expense	463,122	(5,468,149)	836,561
<i>Changes in operating assets and liabilities:</i>			
Trade receivables	2,536,905	(1,857,393)	659,468
Unbilled receivables	(5,501,385)	(5,085,759)	1,155,454
Other accounts receivable and prepaid expenses	44,770	(252,560)	(1,176,895)
Inventories	(1,295,031)	2,067,853	(652,391)
Severance pay, net	(329,857)	(1,894,037)	1,210,662
Trade payables	866,633	1,282,162	(1,532,471)
Other accounts payable and accrued expenses	(154,023)	1,252,630	(103,186)
Deferred revenues	276,466	357,041	(458,544)
Net cash provided by operating activities	3,272,587	1,904,813	2,641,673
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(1,774,166)	(4,824,493)	(1,555,788)
Additions to capitalized software	(937,616)	(588,014)	(364,159)
Proceeds from sale of property and equipment	94,424	33,766	31,343
Net cash used in investing activities	\$ (2,617,358)	\$ (5,378,741)	\$ (1,888,604)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Repayment of long term debt	\$ (2,253,345)	\$ (1,842,998)	\$ (16,682,823)
Proceeds from long term debt	—	2,150,000	11,000,000
Other financing activities	(54,155)	—	—
Change in short term bank credit	408,328	2,119,056	(1,086,968)
Proceeds from sale of common stock, net of offering costs	—	—	2,952,999
Net cash provided by (used in) financing activities	(1,899,172)	2,426,058	(3,816,792)
DECREASE IN CASH, RESTRICTED COLLATERAL DEPOSITS, AND CASH EQUIVALENTS	(1,243,943)	(1,047,870)	(3,063,723)
CASH DIFFERENCES DUE TO EXCHANGE RATE DIFFERENCES	200,147	(863,339)	(234,719)
CASH, RESTRICTED COLLATERAL DEPOSITS AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	\$ 5,488,754	\$ 7,399,963	\$ 10,698,405
CASH, RESTRICTED COLLATERAL DEPOSITS AND CASH EQUIVALENTS AT THE END OF THE YEAR	4,444,958	5,488,754	7,399,963
SUPPLEMENTARY CASH FLOW INFORMATION:			
Interest paid during the year	855,917	765,941	712,558
Income tax paid during the year	415,724	169,584	221,654

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

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL

a. Corporate structure:

Arotech Corporation ("Arotech") and its wholly-owned subsidiaries (the "Company") provide defense and security products for the military, law enforcement, emergency services and homeland security markets, and lithium batteries and chargers, and multimedia interactive simulators/trainers. The Company operates primarily through its wholly-owned subsidiaries: FAAC Incorporated, a Michigan corporation located in Ann Arbor, Michigan (Training and Simulation Division) with a location in Orlando, Florida; Epsilor-Electric Fuel Ltd. ("Epsilor-EFL"), an Israeli corporation located in Beit Shemesh, Israel (between Jerusalem and Tel-Aviv), and Dimona, Israel (in Israel's Negev desert area) (Power Systems Division); and UEC Electronics, LLC ("UEC"), a South Carolina limited liability company located in Hanahan, South Carolina (Power Systems Division).

b. Discontinued operations:

Asset Held for Sale and Discontinued Operations

In August 2016, the Board approved a strategic shift to discontinue the Flow Battery segment ("the segment") with an effective date of August 31, 2016. The principal activities of the Flow Battery segment were research and development related and were focused on developing a commercial application based upon the Iron Flow Storage concept. The assets of the Flow Battery segment of \$270,139 were classified as held for sale as of December 31, 2016. During the fourth quarter of 2017, it was determined that the Company was not able to execute its plan to sell the assets associated with the Flow Battery segment. As a result, assets in the amount of \$270,139 were reclassified on the consolidated balance sheet into property and equipment. These assets are being used in operations and therefore not considered to be impaired as of December 31, 2018.

The amounts presented in the Consolidated Statements of Operations and Comprehensive Income as discontinued operations in 2016 represented research and development and general and administrative expenses. As the Flow Battery segment was reported within the Epsilor-EFL legal entity and the legal entity has net operating loss carryforwards for which the Company has recorded a valuation allowance, there was no tax impact. Included in the Flow Battery segment's general and administrative expenses for the year ended December 31, 2016, was a contractual buyout associated with the termination of the former Chairman of the Flow Battery segment of \$524,052.

The impact of the discontinued operations on operating and investing activities within the consolidated statements of cash flows for the year ended December 31, 2016 was (\$1,337,751) and (\$252,064), respectively.

Unless otherwise indicated, discontinued operations are not included in the reported results. The Notes to the Consolidated Financial Statements relate to the Company's continuing operations.

c. Related parties:

Note Receivable

On February 9, 2000, two former executives entered into non-recourse promissory notes whereby the Company provided the notes to the executives and the executives in turn exercised stock options. The promissory notes originally accrued interest at an annual rate of 1% over the then federal funds rate and are due in 2025. As of December 31, 2018 and 2017, the aggregate amount outstanding pursuant to these promissory notes was \$908,054.

UEC Facility Headquarters

On October 31, 2014, the Company entered into a lease agreement with UEC Properties, LLC, a company controlled by the former owners of UEC, and now consultants and shareholders of the Company, for land and buildings that represent the headquarters of UEC Electronics. The lease term with UEC Properties commenced on January 1, 2015 and it extends for ten years, expiring on December 31, 2024. The lease provides for both the Company and UEC Properties, LLC with a one-time right to terminate the lease as of December 31, 2019, provided a written notice and a termination fee of \$100,000 is delivered

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

at or before December 31, 2018. On December 31, 2018, the Company notified UEC Properties, LLC, that it intends to terminate the lease at the end of 2019 and paid and expensed the termination fee of \$100,000 at time of notice.

The 2018 monthly lease payment was \$31,081 and increases at a rate of 2.5% per year through the term of the lease. Lease expense recognized in 2018, 2017, and 2016 was \$472,972, \$363,875, and \$355,000, respectively.

Admiralty Partners

On February 2, 2016, the Company and Admiralty Partners (the “Investor”) entered into a Stock Purchase Agreement (the “Investment Agreement”) providing for the sale to the Investor of a total of 1,500,000 shares of the Company’s common stock at a price valued at \$1.99 per share. As the Investor was also given the right to nominate a member of the Board of Directors pursuant to the terms of the Investment Agreement, and the shares were issued at a discount to the then market price, this resulted in additional stock compensation expense of \$375,000.

Subsequently, on February 3, 2016, the Company entered into a consulting agreement with the Investor for a period of three years. In exchange, the Company pays an annual fee equal to the difference between total accrued compensation of the Board member and \$125,000. The agreement can be terminated by either party upon sufficient written notice. During the fourth quarter of 2018 the investor and the Company agreed that the current agreement should not be renewed in 2019 and therefore the agreement will expire in accordance with its terms in February 2019. Total compensation expense recognized in 2018, 2017, and 2016 was \$58,000, \$49,000, and \$26,750, respectively.

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”).

a. Principles of consolidation:

The consolidated financial statements include the accounts of Arotech and its wholly owned subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

The United States dollar (“U.S. dollar”) is the currency of the primary economic environment in which the Company’s U.S. subsidiaries operate and the Company has adopted and are using the U.S. dollar as our functional currency. Transactions and balances originally denominated in U.S. dollars are presented at the original amounts. Accordingly, monetary accounts maintained in currencies other than dollars are re-measured into dollars, with resulting gains and losses reflected in the consolidated statements of operations and comprehensive income as financial income or expenses, as appropriate.

In the first quarter of 2018, the Company concluded that the functional currency for our Israeli subsidiary, Epsilor-EFL, changed from the New Israeli Shekel (“NIS”) to the U.S. dollar. The primary reason for the change in functional currencies is due to a change in Epsilor-EFL operations whereby the majority of its contracts and material costs are anticipated to be sourced in U.S. dollars. The Company believes that the change in functional currency for this business was necessary as it reflects the primary economic environment in which Epsilor-EFL now operates.

The change in functional currency for Epsilor-EFL is accounted for prospectively from January 1, 2018, and prior year financial statements have not been restated for the change in functional currency. The financial statements of Epsilor-EFL are now reported in U.S. dollars. All balance sheet accounts were

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

translated using the exchange rates in effect at the time of the change in functional currency. The statements of comprehensive income and cash flows are also reported in U.S. dollars.

c. Cash equivalents:

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

d. Restricted collateral deposits:

Restricted collateral deposits are primarily invested in highly liquid deposits which are used as security for the Company's performance guarantees at Epsilon-EFL.

e. Inventories:

Inventory costs include material, labor, and manufacturing overhead costs, including depreciation and amortization expense associated with the manufacture and distribution of the Company's products. Inventories are stated at lower of cost or net realizable value and expense estimates are made for excess and obsolete inventories. Based on this evaluation, provisions are made to write inventory down to its net realizable value. In 2018, 2017, and 2016, the Company wrote off approximately \$631,021, \$407,202, and \$359,346, respectively, of obsolete inventory, which has been included in the cost of revenues. Cost is determined by weighted average method.

f. Property and equipment:

Depreciation is calculated by the straight-line method over the following estimated useful lives of the assets:

	<u>Depreciable life (in years)</u>
Computers and related equipment	3 to 5
Motor vehicles	5 to 7
Office furniture and equipment	3 to 5
Machinery, equipment and installations	5 to 10
Buildings	30
Land	Not depreciated
Leasehold improvements	Shorter of the term of the lease or the life of the asset
Demo inventory	3 to 5

The Company tests long-lived asset groups for recoverability when changes in circumstances indicate the carrying value may not be recoverable, for example, when there are material adverse changes in projected revenues or expenses, significant underperformance relative to historical or projected operating results, or significant negative industry or economic trends. The Company also performs a test for recoverability when management has committed to a plan to sell or otherwise dispose of an asset group. The Company evaluates recoverability of an asset group by comparing its carrying value to the future net undiscounted cash flows that the Company expects will be generated by the asset group. If the comparison indicates that the carrying value of an asset group is not recoverable, the Company recognizes an impairment loss for the excess of carrying value over the estimated fair value. When the Company recognizes an impairment loss for assets to be held and used, the Company depreciates the adjusted carrying amount of those assets over their remaining useful life. No impairment losses were recognized in the Statements of Operations and Comprehensive Income for all periods presented.

g. Goodwill and other intangible assets:

Certain business acquisitions have resulted in the recording of goodwill and indefinite-life intangible assets, primarily trademark assets, which are not amortized.

Goodwill is tested for impairment at the reporting unit level, which is the operating segment or one level below the operating segment, also known as a component. Two or more components of an operating segment shall be aggregated into a single reporting unit if the components have similar economic characteristics, based on an assessment of various factors. The Company has determined that the Training and Simulation Division and the Power System Division segments are separate reporting units.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company has historically performed its annual goodwill impairment test as of December 31 each year. During the quarter ended September 30, 2018, the Company voluntarily changed its annual impairment assessment date from December 31 to October 1. The Company believes this change in measurement date, which represents a change in method of applying an accounting principle, is preferable under the circumstances as it better aligns with its forecasting and annual budgeting process timeline. The Company does not believe that change in valuation date produced different impairment results.

When testing goodwill for impairment, the Company may conduct a qualitative assessment by analyzing a variety of factors that could influence the fair value of the reporting unit or indefinite-life intangible, including, but not limited to: the results of prior quantitative assessments performed; changes in the carrying amount of the reporting unit or indefinite-life intangible; actual and projected revenue and operating margin; relevant market data for both the Company and its peer companies; industry outlooks; macroeconomic conditions; liquidity; changes in key personnel; and the Company's competitive position. The Company uses significant judgment to evaluate the totality of these events and factors to make the determination of whether it is more likely than not that the fair value of the reporting unit or indefinite-life intangible is less than its carrying value.

If the Company determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, it then performs the impairment evaluation using a quantitative assessment. Under the quantitative assessment, the first step identifies whether there is a potential impairment by comparing the fair value of a reporting unit to the carrying amount, including goodwill. If the carrying amount of a reporting unit exceeds the fair value, then a test is performed to determine the implied fair value of goodwill. An impairment loss is recognized based on the amount that the carrying amount of goodwill exceeds the implied fair value. When measuring the fair value of its reporting units in the quantitative assessment, the Company uses widely accepted valuation techniques, applying a combination of the income approach (discounted cash flows) and market approach (market multiples). When preparing discounted cash flow models under the income approach, the Company uses internal forecasts to estimate future cash flows expected to be generated by the reporting units. To discount these cash flows, the Company uses the expected cost of equity, determined by using a capital asset pricing model. The Company believes the discount rates used appropriately reflect the risks and uncertainties in the financial markets generally and specifically in the Company's internally-developed forecasts. When using market multiples under the market approach, the Company applies comparable publicly traded companies' multiples (e.g., earnings or revenues) to its reporting units' actual results.

h. Revenue recognition:

The Company accounts for revenue recognition in accordance with Accounting Standards Codification ("ASC") 606, Revenue from Contracts with Customers, which the Company adopted on January 1, 2018, using the modified retrospective transition approach to all contracts. The Company evaluated the distinct performance obligations and the pattern of revenue recognition of its significant contracts upon adoption of the standard. Consequently, after its review of contracts in each revenue stream, the Company concluded that the impact of adopting the standard did not have an impact to its consolidated balance sheets, statements of operations, changes in stockholders' equity, or cash flows.

During 2018, 2017, and 2016, the Company recognized revenues from (i) the sale and customization of interactive training systems (Training and Simulation Division); (ii) maintenance services in connection with such systems (Training and Simulation Division); (iii) the sale of batteries, chargers and adapters, and custom power solutions (Power Systems Division); and (iv) the sale of lifejacket lights (Power Systems Division).

The Company determines its revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations within the contract
- Determination of the transaction price

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- Allocation of the transaction price to the performance obligations within the contract
- Recognition of revenue when, or as the performance obligation has been satisfied

Performance Obligations. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASC Topic 606. A contract transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. In assessing the recognition of revenue, the Company evaluates whether two or more contracts should be combined and accounted for as one contract and if the combined or single contract should be accounted for as multiple performance obligations which could change the amount of revenue and profit (loss) recorded in a period. The majority of the Company's contracts with customers are accounted for as one performance obligation, as the majority of tasks and services is part of a single project or capability. As these contracts are typically a customized customer-specific solution, the Company uses the expected cost plus margin approach to estimate the standalone selling price of each performance obligation. For contracts with multiple performance obligations, the Company allocates the contracts transaction price to each performance obligation using its best estimate of the standalone selling price of each distinct good or service in the contract.

The Company also offers maintenance and support agreements ("warranties") for many of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the product is sold but typically are for one to two years. The Company estimates its warranty liability by deferring a percentage of the original invoice amount and recording it as Deferred Revenue in its balance sheet. The Company periodically assesses the adequacy of its reserves and adjusts the percentage of revenue deferred as necessary. The warranty revenue is recognized on a straight-line basis over the term of the maintenance and support services. The standalone selling price for extending a warranty is determined based on the original invoice price charged when sold separately or upon renewal. See Note 15, "Warranty," for details of warranty liabilities.

The Company's performance obligations are satisfied over time as work progresses or at a point in time. Revenue from products and services transferred to customers over time accounted for 91%, 93%, and 90% of its revenue for the years ended December 31, 2018, 2017, and 2016, respectively. Substantially all of the Company's revenue in the Training and Simulation Division and the U.S. Power Systems Division is recognized over time. Typically, revenue is recognized over time using an input measure (e.g., costs incurred to date relative to total estimated costs at completion) to measure progress. Contract costs include labor, material, and overhead.

On December 31, 2018, the Company had \$64.8 million in expected future revenue relating to performance obligations currently in progress, which it also refers to as total backlog. The Company expects to recognize approximately 76% of its backlog as revenue in 2019, and the remaining 24% thereafter.

Contract Estimates. Accounting for long-term contracts and programs involves the use of various techniques to estimate total contract revenue and costs. For long-term contracts, the Company estimates the profit on a contract as the difference between the total estimated revenue and expected costs to complete a contract and recognize that profit over the life of the contract.

Contract estimates are based on various assumptions to project the outcome of future events that can exceed a year. These assumptions include labor productivity and availability; the complexity of the work to be performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer.

As a significant change in one or more of these estimates could affect the profitability of its contracts, the Company reviews and updates its contract-related estimates quarterly. The Company recognizes adjustments in estimated profit on contracts under the cumulative catch-up method. Under this method, the impact of the adjustment on profit recorded to date is recognized in the period the adjustment is identified. Revenue and profit in future periods of contract performance is recognized using the adjusted estimate. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, the Company recognizes the total loss in the quarter it is identified.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The aggregate impact of adjustments in contract estimates to net income (loss) is presented below:

	Twelve months ended December 31,					
	2018		2017		2016	
	Training and Simulation Division	Power Sys- tems Division	Training and Simulation Division	Power Sys- tems Division	Training and Simulation Division	Power Sys- tems Division
Net income (loss)	\$ 659,037	\$ 656,665	\$ 955,022	\$ 40,888	\$ 1,856,664	\$ (57,384)

Revenue by Category. As of December 31, 2018, 2017, and 2016, the Company's portfolio of products and services consisted of 471, 457, and 448 active contracts, respectively.

Revenue by major product line was as follows:

Twelve months ended December 31,			
	2018	2017	2016
Product Revenue			
Air Warfare Simulation	\$ 16,864,956	\$ 19,231,716	\$ 19,277,541
Vehicle Simulation	21,650,797	13,709,762	16,598,942
Use-of-Force	14,652,486	14,125,824	9,114,910
Service Revenue			
Warranty	3,539,931	3,187,022	1,367,401
Total Training and Simulation Division	\$ 56,708,170	\$ 50,254,324	\$ 46,358,794
Contract Manufacturing	\$ 15,120,054	\$ 13,544,017	\$ 17,498,310
Power Distribution and Generation	6,007,668	6,948,704	4,687,285
Batteries	13,393,716	21,537,381	19,233,660
Engineering Services and Other	5,370,133	6,438,252	5,197,703
Total Power Division	\$ 39,891,571	\$ 48,468,354	\$ 46,616,958

The table below details the percentage of total recognized revenue by type of arrangement as of December 31, 2018, 2017, and 2016:

Twelve months ended December 31,			
Type of Revenue	2018	2017	2016
Sale of products	94.3%	96.2%	95.3%
Maintenance and support agreements	3.7%	3.2%	4.3%
Long term research and development contracts	2.0%	0.6%	0.4%
Total	100%	100%	100%

Revenue by contract type was as follows:

	Training and Simulation Division	Power Systems Division
<u>Twelve months ended December 31, 2018</u>		
Fixed Price	\$ 46,789,332	\$ 35,865,009
Cost Reimbursement (Cost Plus)	5,269,145	2,929,892
Time and Materials	4,649,693	1,096,670
Total	\$ 56,708,170	\$ 39,891,571

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

	Training and Simulation Division	Power Systems Division
<u>Twelve months ended December 31, 2017</u>		
Fixed Price	\$ 42,042,646	\$ 40,826,800
Cost Reimbursement (Cost Plus)	5,721,623	5,992,567
Time and Materials	2,490,055	1,648,987
Total	<u>\$ 50,254,324</u>	<u>\$ 48,468,354</u>
<u>Twelve months ended December 31, 2016</u>		
Fixed Price	\$ 36,804,593	\$ 37,082,800
Cost Reimbursement (Cost Plus)	5,869,540	6,448,385
Time and Materials	3,684,661	3,085,773
Total	<u>\$ 46,358,794</u>	<u>\$ 46,616,958</u>

Each of these contract types presents advantages and disadvantages. Typically, the Company assumes more risk with fixed-price contracts. However, these types of contracts offer additional profits when the Company completes the work for less than originally estimated. Cost-reimbursement contracts generally subject the Company to lower risk. Accordingly, the associated base fees are usually lower than fees earned on fixed-price contracts. Under time and materials contracts, the Company's profit may fluctuate if actual labor-hour costs vary significantly from the negotiated rates.

Revenues from major customers (as a percentage of consolidated revenues):

Other than for sales to various branches of the United States Military, which accounted for 35%, 33%, and 41%, of consolidated continuing revenues for 2018, 2017, and 2016, respectively, one single customer accounted for more than 10% of revenues for any of the three years presented.

Revenue by customer was as follows:

	Training and Simulation Division	Power Systems Division
<u>Twelve months ended December 31, 2018</u>		
U.S. Government		
Department of Defense (DoD)	\$ 16,862,856	\$ 3,292,382
Non-DoD	11,699,696	–
Foreign Military Sales (FMS)	2,066,140	–
Total U.S. Government	<u>\$ 30,628,692</u>	<u>\$ 3,292,382</u>
U.S. Commercial	\$ 19,889,962	\$ 20,542,135
Non-U.S. Government	2,185,308	2,345,653
Non-U.S. Commercial	4,004,208	13,711,401
Total Revenue	<u>\$ 56,708,170</u>	<u>\$ 39,891,571</u>
<u>Twelve months ended December 31, 2017</u>		
U.S. Government		
Department of Defense (DoD)	\$ 11,056,632	\$ 9,149,874
Non-DoD	11,787,913	–
Foreign Military Sales (FMS)	2,511,023	–
Total U.S. Government	<u>\$ 25,355,568</u>	<u>\$ 9,149,874</u>
U.S. Commercial	\$ 18,895,558	\$ 16,712,654
Non-U.S. Government	3,673,960	12,515,981
Non-U.S. Commercial	2,329,238	10,089,845
Total Revenue	<u>\$ 50,254,324</u>	<u>\$ 48,468,354</u>

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

	Training and Simulation Division	Power Systems Division
Twelve months ended December 31, 2016		
U.S. Government		
Department of Defense (DoD).....	\$ 16,720,606	\$ 11,480,240
Non-DoD	8,908,207	–
Foreign Military Sales (FMS)	1,796,747	–
Total U.S. Government.....	<u>27,425,560</u>	<u>11,480,240</u>
U.S. Commercial	\$ 16,480,123	\$ 16,615,821
Non-U.S. Government.....	1,868,232	7,003,558
Non-U.S. Commercial	584,879	11,517,339
Total Revenue.....	<u>\$ 46,358,794</u>	<u>\$ 46,616,958</u>

Contract Balances. The timing of revenue recognition, billings and cash collections results in billed accounts receivable, unbilled receivables (contract assets), and customer advances and deposits (contract liabilities) on the Consolidated Balance Sheet. The majority of the Company's contract amounts are billed as work progresses in accordance with agreed-upon contractual terms, either at periodic intervals (e.g., biweekly or monthly) or upon achievement of contractual milestones. Billing sometimes occurs subsequent to revenue recognition, resulting in contract assets. However, the Company sometimes receives advances or deposits from its customers, particularly on its international contracts, before revenue is recognized, resulting in contract liabilities. These assets and liabilities are reported on the Consolidated Balance Sheet on a contract-by-contract basis at the end of each reporting period.

	December 31, 2018			December 31, 2017		
	Training and Simulation Division	Power Sys- tems Division	Total	Training and Simulation Division	Power Sys- tems Division	Total
Contract Assets – Current.....	\$ 10,358,679	\$ 7,509,217	\$ 17,867,896	\$ 7,263,461	\$ 8,831,054	\$ 16,094,515
Contract Liabilities – Current.....	(6,697,522)	(357,257)	(7,054,779)	(5,860,345)	(917,968)	(6,778,313)
Net Contract Assets and Liabilities:.....	<u>\$ 3,661,157</u>	<u>\$ 7,151,960</u>	<u>\$ 10,813,117</u>	<u>\$ 1,403,116</u>	<u>\$ 7,913,086</u>	<u>\$ 9,316,202</u>

The \$1,496,915 increase in the Company's net contract assets (liabilities) from December 31, 2017 to December 31, 2018 was due to the timing of milestone payments on certain U.S. Government and commercial contracts.

During the years ended December 31, 2018, 2017, and 2016, the Company recognized \$6,305,886, \$5,693,192, and \$6,622,660 in revenue related to the Company's contract liabilities at December 31, 2017, 2016, and 2015, respectively.

Deferred revenues also include unearned amounts received under maintenance and support services and customer deposits of \$50,000 and \$200,608 for 2018 and 2017, respectively.

The Company did not record any provisions for impairment of its unbilled receivables during the years ended December 31, 2018, 2017 and 2016.

Contract Costs

Certain eligible costs, typically incurred during the initial phases of the Company's service contracts, are capitalized when the costs related directly to the contract, are expected to be recovered, and generate or enhance resources to be used in satisfying the performance obligation. These costs primarily consist of production design. If the carrying amount is not recoverable, an impairment loss is recognized.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Practical Expedients and Exemptions

The Company has elected the following practical expedients and exemptions as allowed under the new revenue guidance:

Sales Commissions

The Company has elected to expense its sales commissions when incurred because the amortization period is less than one year. These costs are recorded within selling and marketing expenses.

Financing

The Company has elected to not adjust the consideration for the effects of a significant financing component as the term of the majority of contracts is twelve months or less.

Sales Tax

The Company acts as an agent in the collection and remittance of sales taxes. Historically, the Company has excluded these amounts from the calculation of revenue. These taxes will continue to be excluded from the transaction price.

Shipping and Handling Costs

The Company has elected to account for shipping and handling activities that are incurred after the customer obtained control of the product as fulfillment costs rather than a separate service provided to the customer for which consideration would need to be allocated.

The Company will continue to account for shipping and handling as fulfillment costs when these costs are incurred prior to the customer obtaining control.

i. Trade receivables:

Trade receivables include amounts billed and currently due from customers. The amounts are recorded at net estimated realizable value. The value of the Company's trade receivables when appropriate includes an allowance for estimated uncollectible amounts. The Company calculates an allowance based on its history of write-offs, the assessment of customer creditworthiness, and the age of the outstanding receivables.

As of December 31, 2018 and 2017, the Company's trade receivables recorded in the consolidated balance sheets were \$16,259,809 and \$19,258,960, respectively. The Company has not recorded any provisions for doubtful accounts and no reserves have been established at December 31, 2018 or 2017, respectively. The Company believes its exposure to concentrations of credit risk is limited due to the nature of its operations, where a significant number of its contracts are typically a customized customer specific solution.

j. Research and development cost:

The Company capitalizes certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products are generally charged to expenses as incurred. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release have been capitalized. Capitalized software costs will be amortized using the straight-line method over the estimated useful life of the product (three to five years). The Company assesses the net realizable value of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analysis, management believes that no impairment of capitalized software development costs exists as of December 31, 2018.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In 2018 and 2017, the Training and Simulation Division capitalized \$937,616 and \$588,014, respectively, in software development costs that will be amortized on a straight-line method over the useful life of the software.

k. Income taxes:

The Company accounts for income taxes under the asset and liability method, whereby deferred tax assets and liability account balances are determined based on tax credit carryforwards and differences between the financial reporting and the tax basis 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.

Accounting standards prescribe a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company must determine whether it is “more-likely-than-not” that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. Uncertain tax positions require determinations and estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If the Company’s determinations and estimates prove to be inaccurate, the resulting adjustments could be material to the Company’s future financial statements. As part of preparing our 2018 consolidated financial statements, the Company identified errors in the accounting for income taxes as described further in Note 3, “Restatement of Previously Issued Consolidated Financial Statements,” and Note 12, “Income Taxes.”

l. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, restricted collateral deposits and trade receivables. Cash and cash equivalents are invested mainly in U.S. dollar deposits with the U.S. banks and in NIS with major Israeli banks. Such deposits in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company’s investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are mainly derived from sales to customers located primarily in the United States and Israel along with the countries listed in Note 14, “Segment Information.” Management believes that credit risks are moderated by the diversity of its end customers and geographical sales areas. The Company performs ongoing credit evaluations of its customers’ financial condition.

The Company had no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign currency hedging arrangements as of December 31, 2018 and 2017.

m. Basic and diluted net income per share:

Basic net income per share is computed based on the weighted average number of shares of common stock and participating securities outstanding during each year. Diluted net income per share includes the dilutive effect of additional potential common stock issuable under its share-based compensation plans, using the “treasury stock” method. Unvested restricted stock issued to its employees and directors are “participating securities” and as such, are included, net of estimated forfeitures, in the total shares used to calculate the Company’s basic and diluted net income per share. In the event of a net loss, unvested restricted stock awards are excluded from the calculation of both basic and diluted net loss per share. The total weighted average number of shares related to the outstanding common stock equivalents excluded from the calculations of diluted net income per share were none for the years ended December 31, 2018, 2017, and 2016.

n. Accounting for stock-based compensation

Stock-based awards to employees are recognized as compensation expense based on the calculated fair value on the date of grant. The costs are amortized over the straight line vesting period. The Company granted restricted stock and restricted stock units in 2018, 2017, and 2016. The Company adjusts it re-

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

stricted stock and restricted stock units based upon actual forfeitures. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock.

o. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating their fair value disclosures for financial instruments using the required three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which may require the Company to develop its own assumptions.

The carrying amounts of cash and cash equivalents, restricted collateral deposits, trade and other receivables, short-term bank credit, and trade payables approximate their fair value due to the short-term maturity of such instruments (Level 1).

The fair values of long-term promissory notes are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. The carrying amount of the long-term debt and contractual severance approximates the estimated fair values at December 31, 2018, based upon the Company's ability to acquire similar debt or fulfill similar obligations at similar maturities (Level 2).

p. Severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to 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. Israeli employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability for all of its Israeli employees is fully provided for by monthly deposits into severance pay funds held by insurance companies on behalf of the employees, insurance policies and by accrual. The fair value of these funds, which are considered Level 2 fair value measurements, is recorded as an asset in the Company's consolidated balance sheet.

In addition, according to certain employment agreements, the Company is obligated to provide for special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. During the years ended December 31, 2018 and 2017, the Company had made provisions of \$78,014 and \$106,080, respectively, for this special severance pay.

As of December 31, 2018 and 2017 the unfunded severance pay amounted to \$285,495 and \$141,956, respectively. Severance expenses from continuing operations for the years ended December 31, 2018, 2017, and 2016, amounted to \$384,102, \$727,835, and \$1,388,814, respectively.

In April 2018, the Company made a severance payment of \$263,000, upon the March 31, 2018 retirement of its former Chief Financial Officer.

In December 2016, the Company and its former Chief Executive Officer ("former Executive") signed an agreement whereby the Company and the former Executive agreed to early termination of the former Executive's employment agreement. The additional expense recorded in 2016, related to the termination, was approximately \$926,243.

q. Advertising costs:

The Company records advertising costs as incurred. Advertising expense for the years ended December 31, 2018, 2017, and 2016, was approximately \$278,420, \$93,664, and \$71,730, respectively.

r. New accounting pronouncements:

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. In addition, in July 2018, the FASB issued ASU No. 2018-10, *Codification Improvement to Topic 842*.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In July 2018, the FASB issued ASU No. 2018-11, *Targeted Improvements to Topic 842*. This amendment provides the Company with an additional and optional transition method to adopt the new leases standard. Under this new transition method, the Company can apply the new lease standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption and present the accounting on a prospective or go-forward basis instead of applying to the earliest comparative period presented in the financial statements. The standard will be effective for the Company beginning January 1, 2019.

The Company has elected to apply the new transition method upon adoption of the new standard. The Company also elected the available practical expedients on adoption. In preparation for adoption of the standard, the Company finalized changes to systems, implemented internal controls and key processes to enable the preparation of financial information.

The new standard will likely have a material impact on the Company's Consolidated Balance Sheets. However, is not expected to have a material impact to the Company's Consolidated Statements of Operations and Comprehensive Income, and Consolidated Statement of Cash Flows. The most significant impact will be the recognition of ROU assets and lease liabilities for operating leases and will result in additional ROU assets and lease liabilities for operating leases of approximately \$3.9 million and \$4.0 million, respectively, as of January 1, 2019.

In August 2016, the FASB issued ASU No. 2016-15 (Topic 230), *Classification of Certain Cash Receipts and Cash Payments*. The amendments provide guidance on eight specific cash flow issues for which the current accounting framework does not provide specific guidance. The amendments are effective for annual periods beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The Company adopted the requirements of the new standard in the first quarter of 2018, as required by the new standard.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230), Restricted Cash*, which requires that restricted cash be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The provisions of ASU 2016-18 are effective for years beginning after December 15, 2017, with early adoption permitted. The Company adopted the requirements of the new standard in the first quarter of 2018 using the retrospective transition method, as required by the new standard. The adoption of this ASU had an immaterial impact to our consolidated statements of cash flows.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The new standard simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test and requires businesses to perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and recognizing an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The amendments are effective for annual periods beginning after December 15, 2019 with early adoption permitted for goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect that the adoption of the new standard will have a material impact on its consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, *Income Statement-Reporting Comprehensive Income (Topic 220), Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("AOCI")*. The accounting standard allows for the optional reclassification of stranded tax effects within accumulated other comprehensive income to retained earnings that arise due to the enactment of the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). The amount of the reclassification would reflect the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of the Tax Act and other income tax effects of the Tax Act on items remaining in accumulated other comprehensive income. The standard, will be effective for annual periods beginning after December 15, 2018, including interim periods within that reporting period with early adoption permitted. The Company is currently evaluating the impact of its pending adoption of the new standard on its consolidated financial statements.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

s. Use of estimates:

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

t. Reclassification:

Prior period amounts are reclassified, when necessary, to conform to the current period presentation.

u. Business combinations:

The Company recognizes the assets acquired and liabilities assumed in business combinations on the basis of their fair values at the date of acquisition. The Company assesses the fair value of assets, including intangible assets, using a variety of methods and each asset is measured at fair value from the perspective of a market participant. The method used to estimate the fair values of intangible assets incorporates significant assumptions regarding the estimates a market participant would make in order to evaluate an asset, including a market participant's use of the asset and the appropriate discount rates for a market participant. Assets recorded from the perspective of a market participant that are determined to not have economic use for us are expensed immediately. Any excess purchase price over the fair value of the net tangible and intangible assets acquired is allocated to goodwill. Transaction costs and restructuring costs associated with a business combination are expensed as incurred.

NOTE 3: — RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS

The U.S. Tax Cuts and Jobs Act (the "Tax Act") was enacted on December 22, 2017. The Tax Act made broad complex changes to the U.S. tax code including but not limited to, reduction of the U.S. federal corporate tax rate from 35% to 21%, requiring companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, creating new taxes on certain foreign sourced earnings and additional limitations on the deductibility of interest, and allowing for the indefinite carryforward of net operating losses ("NOL") arising in a taxable year after December 31, 2017, which would be considered an indefinite lived asset. The future use of these NOLs as a deduction are limited to 80% of taxable income in a single year, and the carryback of these NOLs to offset prior year taxable income is no longer permitted. The Company recorded a provisional deferred income tax benefit of \$3.2 million in the period ended December 31, 2017 related to the change in the corporate tax rate from 35% to 21%. However, as a result of the Tax Act, deferred tax assets related to any deductible temporary differences, other than NOLs, that will reverse in future periods will convert to NOL carryforwards with an indefinite carryforward period. This allows U.S. federal deferred tax liabilities for indefinite lived intangible assets to be used as a source of income for U.S. federal indefinite lived deferred tax assets when determining if a valuation allowance is needed for these U.S. federal non-NOL deferred tax assets. No valuation allowance reversal relating to this was recorded in the period of enactment, resulting in the Company concluding that the previously issued 2017 consolidated financial statements were misstated. Accordingly, the Company has restated its 2017 consolidated financial statements to reflect the impact of releasing a portion of the previously reported valuation allowance associated with the expected reversal of the U.S. federal non-NOL deferred tax assets. This resulted in an increase in the deferred income tax benefit for 2017 of \$3.2 million and a corresponding increase to net income and earnings per share.

These errors had no impact on any period prior to 2017, and, further, there is no impact on the previously disclosed cash taxes and the effect of the restatement to the consolidated statements of cash flows is limited to changes within operating activities as noted below, and, therefore, there are no impacts on the operating, investing or financing subtotals. Refer to Note 16, "Quarterly Results of Operations (Unaudited)," for the impact of correcting these previously reported errors on our unaudited quarterly results.

The impacts of the \$3.2 million adjustment to income tax benefit for 2017 is as follows:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 3:— RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)

	Year Ended December 31, 2017	
	As Reported	As Restated
Consolidated Statements of Operations and Comprehensive Income (Loss):		
Income tax (benefit) expense.....	\$ (2,024,130)	\$ (5,224,875)
Net income (loss).....	\$ 3,834,136	\$ 7,034,881
Comprehensive income (loss)	\$ 5,586,742	\$ 8,787,487
Basic net income (loss) per share.....	\$ 0.15	\$ 0.27
Diluted net income (loss) per share	\$ 0.15	\$ 0.27

	As of December 31, 2017	
	As Reported	As Restated
Consolidated Balance Sheets:		
Deferred tax liabilities.....	\$ 5,600,721	\$ 2,399,976
Total long-term liabilities	\$ 18,986,164	\$ 15,785,419
Total liabilities	\$ 45,304,958	\$ 42,104,213
Accumulated deficit.....	\$ (181,568,757)	\$ (178,368,012)
Total equity	\$ 71,093,218	\$ 74,293,963
Total liabilities and stockholders' equity	\$ 116,398,176	\$ 116,398,176

	Year Ended December 31, 2017	
	As Reported	As Restated
Consolidated Statements of Cash Flows:		
Net income (loss).....	\$ 3,834,136	\$ 7,034,881
Deferred tax (benefit) expense	\$ (2,267,404)	\$ (5,468,149)

The impacts of the restatement have been reflected throughout the financial statements, including the applicable footnotes, as appropriate.

NOTE 4:— OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

The following is a summary of other accounts receivable and prepaid expenses as of December 31, 2018 and 2017:

	December 31,	
	2018	2017
Government authorities.....	\$ 480,937	\$ 733,360
Israeli statutory severance pay fund.....	253,382	—
Employees	42,471	67,504
Prepaid expenses	820,381	1,359,055
Other	4,392,092	182,301
Total	<u>\$ 5,989,263</u>	<u>\$ 2,342,220</u>

a. In connection with the settlement proposal related to the termination for convenience contract by the United States Marine Corps (“USMC”) with Science Applications International Corporation (“SAIC”) we have reclassified amount previously reported in accounts receivable and unbilled receivables of \$330,095 and \$3,728,004, respectively, to Other. See Note 10, “Commitments and Contingent Liabilities,” for additional discussion.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 5:– INVENTORIES

The following is a summary of inventories as of December 31, 2018 and 2017:

	December 31,	
	2018	2017
Raw and packaging materials.....	\$ 7,912,883	\$ 6,843,479
Work in progress	1,626,960	718,085
Finished products	372,905	1,093,314
Total	<u>\$ 9,912,748</u>	<u>\$ 8,654,878</u>

NOTE 6:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2018	2017
Cost:		
Computers and related equipment.....	\$ 3,248,394	\$ 3,500,548
Motor vehicles.....	845,246	962,095
Office furniture and equipment.....	1,835,618	1,664,035
Machinery, equipment and installations	10,630,960	9,522,420
Buildings	4,389,249	4,344,803
Land.....	300,000	300,000
Leasehold improvements	1,711,196	1,959,587
Demo inventory.....	2,106,332	1,683,484
Total costs	<u>25,066,995</u>	<u>23,936,972</u>
Accumulated depreciation:		
Computers and related equipment.....	2,455,892	2,590,718
Motor vehicles.....	433,134	324,433
Office furniture and equipment.....	1,382,010	1,479,613
Machinery, equipment and installations	8,156,024	6,928,337
Buildings	964,737	729,051
Leasehold improvements	1,196,432	1,284,742
Demo inventory.....	1,564,519	1,323,990
Total accumulated depreciation	<u>16,152,748</u>	<u>14,660,884</u>
Property and equipment, net.....	<u>\$ 8,914,247</u>	<u>\$ 9,276,088</u>

b. Depreciation expense amounted to \$1,990,577, \$1,835,308, and \$1,789,041 for the years ended December 31, 2018, 2017, and 2016, respectively. Included in the 2016 depreciation expense is \$36,957 related to discontinued operations.

NOTE 7:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

Goodwill and indefinite lived assets are assessed annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. For the years ended December 31, 2018 and 2017, respectively, the Company performed a qualitative assessment for its Training and Simulation reporting unit and the Company determined that it was more likely than not that the fair values of its reporting unit exceeded its carrying value.

For its Power Systems reporting unit, the Company determined that it was necessary to perform a quantitative assessment of goodwill for the purpose of determining whether an impairment existed at October 1, 2018. When conducting this analysis, the Company engaged third party valuation experts with a detailed understanding of its Power Systems reporting unit to perform a valuation of the Power Systems reporting unit on a going concern basis. The Company prepared a discounted cash flow analysis over a five year

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 7:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET (Cont.)

period so as to derive a reasonable view of the cash flows that the Power Systems reporting unit is projected to generate from 2019-2023.

As a result of this analysis, the Company concluded that the goodwill recorded in relation to the Power Systems reporting unit was not impaired at December 31, 2018.

A summary of the goodwill by business segment is as follows:

	December 31, 2018	December 31, 2017
Training and Simulation Division	\$ 24,435,641	\$ 24,435,641
Power Systems Division	21,702,395	21,702,395
Total	<u>\$ 46,138,036</u>	<u>\$ 46,138,036</u>

b. Other intangible assets:

	Original Useful life	December 31,			
		2018		2017	
		Cost	Net book value	Cost	Net book value
Technology	4 - 8 years	\$ 9,988,000	\$ 501,000	\$ 9,988,000	\$ 980,750
Capitalized software costs	1 - 3 years	6,499,735	1,268,278	5,562,119	741,355
Trademarks	10 years	28,000	–	28,000	–
Backlog/customer relationship	1 - 10 years	2,844,000	–	2,844,000	–
Covenant not to compete	6 years	400,000	29,000	400,000	76,000
Customer list	2 - 10 years	14,173,645	1,868,500	14,173,645	2,608,500
		33,933,380	<u>\$ 3,666,778</u>	32,995,764	<u>\$ 4,406,605</u>
Less - accumulated amortization...		(30,266,602)		(28,589,159)	
Amortized cost		3,666,778		4,406,605	
Trademarks (indefinite lives)		799,000		799,000	
Net book value		<u>\$ 4,465,778</u>		<u>\$ 5,205,605</u>	

Amortization expense amounted to \$1,677,443, and \$2,205,755, and \$2,875,543 for the years ended December 31, 2018, 2017, and 2016, respectively, including amortization of capitalized software costs of \$410,693, \$397,000, and \$88,010, respectively.

c. Estimated amortization expenses, using both straight line and accelerated amortization methods, for the years shown is as follows:

Twelve months ending December 31,	
2019	\$ 1,233,065
2020	789,212
2021	506,213
2022	427,650
2023	520,523
Thereafter	190,115
Total	<u>\$ 3,666,778</u>

NOTE 8:– LOANS

The Company maintains credit facilities with JPMorgan Chase Bank, N.A. (“Chase”), whereby Chase provides (i) a \$15,000,000 revolving credit facility (“Revolver”), (ii) a \$10,000,000 Term Loan (“Term Loan A”), (iii) a \$1,730,895 Mortgage Loan (“Term Loan B”) and (iv) a \$1,358,000 Mortgage Loan (“Term Loan C”); collectively referred to as the “Credit Facilities.”

The maturity of the Revolver is March 11, 2021. The Revolver maintains an interest rate on a scale ranging from LIBOR plus 1.75% up to LIBOR plus 3.00%. The effective interest rate for the revolver at December 31, 2018 was 5.50%. The balance at December 31, 2018 and December 31, 2017 was \$5,500,416 and \$5,092,088, respectively.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 8:– LOANS (Cont.)

The maturity of the Term Loan A is March 11, 2021. Term Loan A maintains an interest rate on a scale ranging from LIBOR plus 2.0% up to LIBOR plus 3.25%. The repayment of Term Loan A consists of 60 consecutive monthly payments of principal plus accrued interest based on annual principal reductions of 10% during the first year, 20% during the second through fourth years, and 30% during the fifth year. The effective interest rate for the Term Loan at December 31, 2018 was 5.75%. The balance at December 31, 2018 and December 31, 2017 was \$5,656,291 and \$7,656,291, respectively.

During the quarter ended June 30, 2017, the Company's Training and Simulation Division, in Ann Arbor, Michigan purchased land and a building for \$2,150,000. As a result, the Company now maintains two Mortgage Loans ("Term Loans B and C"). The maturities of Term Loans B and C are June 1, 2024 and maintain an interest rate on a scale identical to Term Loan A. The monthly payments on Term Loan B and Term Loan C are \$7,212 and \$5,660, respectively, in principal plus accrued interest, with balloon payments due on the maturity date. The effective interest rate for the Mortgage Loans at December 31, 2018 was 5.75%. At December 31, 2018, the balance of Term Loans B and C was \$2,844,327 and at December 31, 2017, the balance of Term Loan B was \$2,998,791.

The Credit Facilities maintain certain reporting requirements, conditions precedent, affirmative covenants and financial covenants. The Company is required to maintain certain financial covenants that include a Maximum Debt to EBITDA ratio of 3.00 to 1.00 and a Minimum Fixed Charge Coverage Ratio of 1.20 to 1.00. The Company was in compliance with its covenants at December 31, 2018.

The Credit Facilities are secured by the Company's assets and the assets of the Company's domestic subsidiaries.

Minimum loan payments for the Term and Mortgage Loans are as follows:

Minimum loan payments	December 31,
2019	\$ 2,204,653
2020	2,835,546
2021	1,144,088
2022	154,464
2023	154,464
Thereafter	2,072,007
Total	<u>\$ 8,565,222</u>

NOTE 9:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

The following is a summary of other accounts payable and accrued expenses as of December 31, 2018 and 2017:

	December 31,	
	2018	2017
Employees and payroll accruals.....	\$ 3,628,290	\$ 3,309,950
Accrued vacation pay.....	1,029,907	1,082,105
Accrued expenses.....	1,030,590	1,205,713
Severance.....	482,053	–
Government authorities.....	327,205	1,042,386
Total	<u>\$ 6,498,045</u>	<u>\$ 6,640,154</u>

NOTE 10:– COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

Under Epsilor-EFL's research and development agreements with the Office of the Chief Scientist ("OCS"), and pursuant to applicable laws, Epsilor-EFL is required to pay royalties at the rate of 3.0%-3.5% of net sales of products developed with funds provided by the OCS, up to an amount equal to 100% of research and development grants received from the OCS. Amounts due in respect of projects approved after 1999 also bear interest at the LIBOR rate. Epsilor-EFL is obligated to pay royalties only on sales of products in

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

respect of which OCS participated in their development. Should the project fail, Epsilor-EFL will not be obligated to pay any royalties or refund the grants. No royalties were expensed for 2018, 2017, and 2016.

During 2018, 2017, and 2016, Epsilor-EFL received grants in the total amount of \$500,271, \$461,894, and \$612,249, respectively.

b. Lease commitments:

The Company rents its facilities and certain equipment under various operating lease agreements, which expire on various dates through 2023. The minimum rental payments under non-cancelable operating leases are as follows:

December 31	Minimum rental payments
2019	\$ 1,161,909
2020	753,383
2021	527,295
2022	441,243
2023	334,722
Thereafter	1,508,915
Total	<u>\$ 4,727,467</u>

Total rent expense for the years ended December 31, 2018, 2017, and 2016, was \$1,275,785, \$1,332,758, and \$1,418,136, respectively.

c. Guarantees:

The Company obtained bank guarantees in the amount of \$182,500 (i) in connection with obligations of one of the Company's subsidiaries to the Israeli Customs Authorities, and (ii) given in order to secure payments made by customers prior to delivery of the final product for milestones achieved during production.

d. Liens:

As security for compliance with the terms related to the investment grants from the State of Israel, Epsilor-EFL has registered floating liens (that is, liens that apply not only to assets owned at the time but also to after-acquired assets) on all of its assets, in favor of the State of Israel.

The Company does not have any credit liens collateralized by the assets of, or guaranteed by, the Company.

Epsilor-EFL has recorded a lien on all of its assets in favor of its banks to secure overdraft protection. In addition Epsilor-EFL has a specific pledge on assets in respect of which government guaranteed loans were given.

e. Litigation and other claims:

The Company from time to time is involved in legal proceedings and other claims. The Company is required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. The Company has not made any material changes in its accounting methodology used to establish its self-insured liabilities during the past three fiscal years.

A determination of the amount of reserves required, if any, for any contingencies are made after careful analysis of each individual issue. The required reserves may change due to future developments in each matter or changes in approach, such as a change in settlement strategy in dealing with any contingencies, which may result in higher net loss.

If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

f. Government Termination for Convenience:

On October 3, 2018, the Company's U.S. Power Systems Division subsidiary was informed by its customer, SAIC, that the USMC had discontinued its efforts to upgrade the Assault Amphibious Vehicle ("AAV") fleet that was undergoing survivability and electrical upgrades under a prime contract with SAIC.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

As a result of this termination for the USMC's convenience, the Company presented its costs related to this program for reimbursement by SAIC and the USMC in December 2018. The amounts of and time frame for resolution have not yet been determined..

NOTE 11:– STOCK-BASED COMPENSATION

a. Stockholders' rights:

The Company's shares confer upon the holders the right to receive notice to participate and vote in the general meetings of the Company and right to receive dividends, if and when declared.

b. The Company has adopted the following stock award plans, whereby options may be granted for purchase of shares of the Company's common stock and where restricted shares and restricted stock units may be granted if approved by the Board of Directors. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock. Under the terms of the award plans, the Board of Directors or the designated committee grants options, restricted stock and restricted stock units. The Board of Directors or the designated committee also determines the vesting period and the exercise terms.

1. 2017 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 704,100 were available for future grants to outside directors as of December 31, 2018.
2. 2009 Equity Incentive Plan – 5,000,000 shares reserved for issuance, of which 2,567,392 were available for future grants to employees and consultants as of December 31, 2018.
3. Under these plans, restricted shares and restricted stock units generally vest after one to three years or pursuant to defined performance criteria; in the event that employment or the director is terminated within that period, unvested restricted shares and restricted stock units generally revert back to the Company.
4. Stock compensation expense is recorded ratably over the vesting period of the option or the restriction period of the restricted shares and restricted stock units. The stock compensation expense that has been charged in the consolidated statements of comprehensive income in respect of restricted shares and restricted stock units to employees and directors in 2018, 2017, and 2016, was \$779,194, \$421,430, and \$878,007, respectively.
5. A summary of the status of the Company's restricted shares and restricted stock units granted as of December 31, 2018 and 2017, and changes during the years ended on those dates, is presented below:

Restricted Shares and Restricted Stock Units:

	2018		2017	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
Outstanding on January 1	240,433	\$ 3.11	389,963	\$ 2.44
Changes during year:				
Restricted stock granted	86,900	\$ 3.29	109,320	\$ 3.20
Restricted units granted	172,500	\$ 3.55	198,000	\$ 3.50
Vested / Released.....	(139,313)	\$ 3.18	(166,847)	\$ 2.45
Forfeited / Canceled.....	(72,942)	\$ 3.39	(290,003)	\$ 2.89
Outstanding on December 31	287,578	\$ 3.32	240,433	\$ 3.11
Restricted shares vested at end of year.....	3,932,740	\$ 2.30	3,793,427	\$ 2.27

6. The remaining total compensation cost related to non-vested restricted share and restricted stock unit awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2018 was \$106,111. The weighted average period over which this compensation cost is expected to be recognized is approximately one and a half years.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:– INCOME TAXES

a. General:

Prior year amounts have been restated to reflect the correction of an error discussed in Note 3, “Restatement of Previously Issued Consolidated Financial Statements.”

The U.S. Tax Cuts and Jobs Act (“Tax Act”) was enacted on December 22, 2017. The Tax Act makes broad complex changes to the U.S. tax code including, but not limited to, reduction of the U.S. federal corporate tax rate from 35% to 21%, requiring reversing U.S. federal non-NOL deferred tax assets to become an NOL carryforward with an indefinite carryforward period, requiring companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creating new taxes on certain foreign sourced earnings and additional limitations on the deductibility of interest.

The SEC issued Staff Accounting Bulletin No. 118 (SAB 118) in December, 2017, to provide guidance on accounting for the effects of the Tax Act. SAB 118 provides for a measurement period of up to one year from the Tax Act enactment date for companies to complete their assessment of and accounting for those effects of the Tax Act. Under SAB 118, a company must first reflect the income tax effects of the Tax Act for which the accounting is complete in the period of the date of enactment. To the extent the accounting for other income tax effects is incomplete, but a reasonable estimate can be determined, companies must record a provisional estimate to be included in their financial statements. The measurement period ended during the fourth quarter of 2018 and we completed our accounting for the effects of the Tax Act and did not make material adjustments to the amounts recorded in 2018. However, we did adjust for the restatement for the income tax accounting errors in 2017 as described in Note 3, “Restatement of Previously Issued Consolidated Financial Statements.”

In 2017 (as restated), the Company recorded tax benefits related to the enactment-date effects of the Tax Act that included adjusting deferred tax assets and liabilities for the change in tax rates of \$3.2 million and recognizing the effects of U.S. federal non-NOL deferred tax assets that convert to indefinite lived thereby allowing for indefinite lived U.S. federal deferred tax liabilities available to use as a source of future taxable income of \$3.2 million. These enactment-date changes resulted in the Company’s negative effective tax rate in 2017 of (289)%.

For the period ending December 31, 2017 the Company had no liabilities associated with the one-time tax on accumulated foreign earnings provision of the Tax Act due to the accumulated net loss position of the foreign subsidiary.

Beginning in 2018, the Tax Act provides a 100% deduction for dividends received from 10-percent owned foreign corporations by U.S. corporate shareholders, subject to a one-year holding period. Although dividend income is now exempt from U.S. federal tax in the hands of the U.S. corporate shareholders, companies must still apply the guidance of ASC 740-30-25-18 to account for the tax consequences of outside basis differences and other tax impacts of their investments in non-U.S. subsidiaries. Upon completion of the Company’s analysis it was determined that the recording of a deferred tax liability on the outside basis difference of the foreign subsidiary was not required as of December 31, 2018 due to the existence of accumulated losses. The Company has asserted that it will permanently reinvest any future earnings from the foreign subsidiary back into its operations.

The Act subjects a US shareholder to tax on GILTI earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income (GILTI)*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary basis differences expected to reverse as GILTI in future years or to provide for the tax expense related to GILTI in the year the tax is incurred as a period expense only. The Company has elected to account for GILTI in the year the tax is incurred. The Company has determined that it has no tax expense related to GILTI in 2018.

The Tax Act allows for the indefinite carryforward of NOL arising in a taxable year ending after December 31, 2017, which would be considered an indefinite lived asset. The amendments limit the future usage of such NOL deductions to 80 percent of taxable income in a single year, and disallow the carryback of NOLs to prior years with taxable income. The Company did not generate any NOL in the tax year ended December 31, 2018.

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- INCOME TAXES (Cont.)

As of December 31, 2018, the Company had existing NOL carryforwards arising from tax years prior to 2018 for U.S. federal income tax purposes of \$33.8 million, which are available to offset future taxable income, if any, expiring in 2021 through 2037. Utilization of U.S. net operating losses for tax years ending on or before December 31, 2017 is subject to substantial annual limitations due to the “change in ownership” provisions 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.

At December 31, 2018, the Company had net deferred tax assets before valuation allowance of \$34.0 million. The deferred tax assets are primarily composed of federal, state and foreign tax NOL carryforwards. Due to uncertainties surrounding the Company’s ability to generate future taxable income to realize these assets, a valuation allowance has been established to offset certain of its net deferred tax assets. Additionally, the future utilization of the Company’s NOL carryforwards to offset future taxable income is subject to a substantial annual limitation as a result of IRC Section 382 changes that have occurred. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance.

The Company has indefinite-lived intangible assets consisting of trademarks and goodwill. These intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a “naked tax credit.” This deferred tax liability could remain on the Company’s balance sheet permanently unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of. Due to the fact that the aforementioned deferred tax liability could have an indefinite life, these U.S. federal deferred tax liabilities are being utilized as a future source of taxable income against its U.S. federal non-NOL deferred tax assets that will reverse into net operating losses with an unlimited carryforward period, as allowed by the Tax Act.

The Company has also evaluated its income tax positions under FASB ASC 740-10 as of December 31, 2018 and the Company believes that it has no material uncertain tax positions and therefore has no uncertain tax position reserves and does not expect to provide for any such reserves. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. It is the Company’s policy that any assessed penalties and interest on uncertain tax positions would be charged to income tax expense.

The Company files a consolidated federal income tax return for its U.S. entities, along with returns for its subsidiaries, which are filed with various state, local and foreign jurisdictions.

b. Israeli subsidiary (Epsilor-EFL):

Epsilor-EFL’s tax rate was 24% for 2018, 24% for 2017 and 25% for 2016. Beginning in 2018, dividends paid from the profits of Epsilor-EFL are no longer subject to tax in the hands of their recipient. Management has indicated that it has no intention of declaring a dividend, and that any future earnings from the operations of Epsilor-EFL will continue to be permanently reinvested into those operations. Due to these assertions, the Company has not recorded a deferred tax liability on the outside basis difference of its foreign subsidiary as of December 31, 2018.

The Israeli government has established certain development zones so as to incentivize business development and export activities. Companies that reside in this zone and meet certain criteria are subject to a favorable tax rates. Epsilor-EFL is located in an approved development zone, however, currently does not meet the criteria established by the government to obtain the tax incentives.

As of December 31, 2018, the Company has tax loss carryforwards, generated by the predecessor of Epsilor-EFL, of \$90.1 million, which is available indefinitely to offset future taxable income. Due to the 2009 merger of EFL-Epsilor, the utilization of the tax loss carryforward is subject to annual limitations.

c. Consolidated deferred income taxes:

Deferred income taxes reflect tax credit carryforwards and the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the bases of the

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:– INCOME TAXES (Cont.)

assets and liabilities used for income tax purposes. Significant components of the Company's deferred tax assets are as follows:

	December 31,	
	2018	2017 (as restated)
U.S. operating loss carryforward (federal and state).....	\$ 7,743,478	\$ 9,452,111
Foreign operating loss carryforward.....	21,619,611	21,949,779
Total operating loss carryforward.....	<u>29,363,089</u>	<u>31,401,890</u>
Temporary differences:		
Compensation and benefits	156,240	62,038
Warranty reserves.....	1,141,244	871,219
Foreign temporary differences	449,738	684,230
Definite lived intangible assets.....	1,822,770	1,696,965
Fixed assets.....	609,259	864,139
AMT credit	173,638	173,638
All other temporary differences	332,537	420,322
Total temporary differences	<u>4,685,426</u>	<u>4,772,551</u>
Deferred tax asset before valuation allowance	34,048,515	36,174,441
Valuation allowance	(30,284,545)	(32,586,628)
Total deferred tax asset	<u>\$ 3,763,970</u>	<u>\$ 3,587,813</u>
Deferred tax liability – intangible assets.....	\$ 6,627,068	\$ 5,987,789
Net deferred tax liability	<u>\$ 2,863,098</u>	<u>\$ 2,399,976</u>

The Company provided valuation allowances for the deferred tax assets resulting from tax loss carryforwards and foreign temporary differences. At present, management currently believes that it is more likely than not that the deferred tax assets related to the operating loss carryforwards and foreign temporary differences will not be realized. However, as a result of the Tax Act legislation, the Company recorded a partial release of the valuation allowance associated with certain U.S. federal non-NOL deferred tax assets. For the year ended December 31, 2017, the Company recorded a valuation allowance release of \$3.2 million.

d. Income from continuing operations before taxes on income are as follows:

	Year ended December 31		
	2018	2017	2016
Domestic.....	\$ 8,929,239	\$ 476,327	\$ (2,133,486)
Foreign.....	(6,495,643)	1,333,679	1,437,332
Total	<u>\$ 2,433,596</u>	<u>\$ 1,810,006</u>	<u>\$ (696,154)</u>

e. Taxes on income were comprised of the following:

	Year ended December 31		
	2018	2017 (as restated)	2016
Current federal taxes.....	\$ –	\$ –	\$ –
Current state and local taxes.....	329,599	47,316	(24,634)
Deferred taxes.....	463,122	(5,468,149)	836,561
Foreign taxes.....	(229,080)	241,267	–
Taxes in respect of prior years	–	(45,309)	(28,507)
(Benefit)/expense	<u>\$ 563,641</u>	<u>\$ (5,224,875)</u>	<u>\$ 783,420</u>

f. A reconciliation between the theoretical tax expense, assuming all income is taxed at the U.S. federal statutory tax rate applicable to income of the Company, and the actual tax expense as reported in the Statements of Operations and Comprehensive Income is as follows:

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:– INCOME TAXES (Cont.)

	Year ended December 31,		
	2018	2017 (as restated)	2016
Income (loss) from continuing operations before taxes	\$ 2,433,596	\$ 1,810,006	\$ (696,154)
Statutory tax rate	21 %	34 %	34 %
Theoretical income tax on the above amount at the U.S. statutory tax rate	511,055	615,402	(236,692)
Deferred taxes for which valuation allowance was provided	\$ (207,931)	\$ 497,850	\$ 589,912
Non-deductible expenses	34,344	74,153	22,746
State taxes, net of federal benefit	260,383	31,228	(16,258)
Foreign income in tax rates other than U.S. rate	(34,210)	(36,925)	452,219
Taxes in respect of prior years	–	(45,309)	(28,507)
Enactment date and measurement period adjustments from the Tax Act	–	(6,361,274)	–
Actual tax expense	<u>563,641</u>	<u>(5,224,875)</u>	<u>783,420</u>

NOTE 13:– FINANCIAL INCOME (EXPENSE), NET

Financial income (expense), net:

	Year ended December 31,		
	2018	2017	2016
Financial expenses:			
Interest, bank charges and fees	\$ (930,840)	\$ (828,154)	\$ (927,390)
Foreign currency transaction differences, net	(7,028)	(248,505)	(47,873)
Total financial expenses	<u>(937,868)</u>	<u>(1,076,659)</u>	<u>(975,263)</u>
Financial income, net	15,915	–	–
Financial expense, net	<u>\$ (921,953)</u>	<u>\$ (1,076,659)</u>	<u>\$ (975,263)</u>

NOTE 14:– SEGMENT INFORMATION

a. General:

The Company operates in two continuing business segments, see Note 1, “General,” for a brief description of the Company’s business.

The Company’s reportable segments have been determined in accordance with the Company’s internal management structure, which is organized based on operating activities. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based on two primary factors: the segment’s operating income and the segment’s contribution to the Company’s future strategic growth.

b. The following is information about reportable segment gains, losses and assets and are presented after the elimination of intra-segment revenues and expenses:

	Training and Simulation Division	Power Systems Division	Corporate	Total Company
2018				
Revenues from outside customers	\$ 56,708,170	\$ 39,891,571	\$ –	\$ 96,599,741
Depreciation and amortization expenses ⁽¹⁾	(801,480)	(2,866,540)	–	(3,668,020)
Direct expenses ⁽²⁾	(45,436,087)	(39,968,413)	(4,132,595)	(89,537,095)
Segment operating income (loss)	10,470,603	(2,943,382)	(4,132,595)	3,394,626
Total other expense	(250,112)	(22,779)	(688,139)	(961,030)
Income tax (expense) benefit	(292,599)	211,080	(482,122)	(563,641)
Net income (loss)	<u>\$ 9,927,892</u>	<u>\$ (2,755,081)</u>	<u>\$ (5,302,856)</u>	<u>\$ 1,869,955</u>
Segment assets	<u>\$ 54,964,358</u>	<u>\$ 59,763,603</u>	<u>\$ 3,235,684</u>	<u>\$ 117,963,645</u>
Additions to long-lived assets	<u>\$ 1,503,583</u>	<u>\$ 1,208,199</u>	<u>\$ –</u>	<u>\$ 2,711,782</u>

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:- SEGMENT INFORMATION (Cont.)

	Training and Simulation Division	Power Systems Division	Corporate	Total Company
2017 (as restated)				
Revenues from outside customers.....	\$ 50,254,324	\$ 48,468,354	\$ —	\$ 98,722,678
Depreciation and amortization expenses ⁽¹⁾	(963,060)	(3,073,365)	(4,638)	(4,041,063)
Direct expenses ⁽²⁾	(41,642,254)	(46,608,518)	(3,536,022)	(91,786,794)
Segment operating income (loss).....	7,649,010	(1,213,529)	(3,540,660)	2,894,821
Total other expense	(125,168)	(261,455)	(698,192)	(1,084,815)
Income tax (expense) benefit.....	(41,391)	(195,592)	5,461,858	5,224,875
Net income (loss)	<u>\$ 7,482,451</u>	<u>\$ (1,670,576)</u>	<u>\$ 1,223,006</u>	<u>\$ 7,034,881</u>
Segment assets	<u>\$ 52,075,040</u>	<u>\$ 61,216,020</u>	<u>\$ 3,107,116</u>	<u>\$ 116,398,176</u>
Additions to long-lived assets.....	<u>\$ 2,996,452</u>	<u>\$ 2,416,055</u>	<u>\$ —</u>	<u>\$ 5,412,507</u>
	Training and Simulation Division	Power Systems Division	Corporate	Total Company
2016				
Revenues from outside customers.....	\$ 46,358,794	\$ 46,616,958	\$ —	\$ 92,975,752
Depreciation and amortization expenses ⁽¹⁾	(1,113,001)	(3,531,851)	(19,732)	(4,664,584)
Direct expenses ⁽²⁾	(37,646,540)	(43,730,381)	(6,719,970)	(88,096,891)
Segment operating income (loss).....	7,599,253	(645,274)	(6,739,702)	214,277
Total other expense	(31,967)	(39,698)	(838,766)	(910,431)
Income tax (expense) benefit.....	24,634	28,507	(836,561)	(783,420)
Net income (loss)	<u>\$ 7,591,920</u>	<u>\$ (656,465)</u>	<u>\$ (8,415,029)</u>	<u>\$ (1,479,574)</u>
Segment assets	<u>\$ 43,740,316</u>	<u>\$ 58,955,828</u>	<u>\$ 6,444,053</u>	<u>\$ 109,140,197</u>
Additions to long-lived assets.....	<u>\$ 586,068</u>	<u>\$ 1,081,815</u>	<u>\$ —</u>	<u>\$ 1,667,883</u>

⁽¹⁾ Includes depreciation of property and equipment and amortization expenses of intangible assets.

⁽²⁾ Including, *inter alia*, sales and marketing, general and administrative, research and development and other income.

c. Summary information about geographic areas:

The following discloses total revenues according to the locations of the Company's end customers and long-lived assets as of and for the years ended December 31, 2018, 2017, and 2016:

	2018		2017		2016	
	Total revenues	Long-lived Assets	Total revenues	Long-lived Assets	Total revenues	Long-lived assets
U.S.A.....	\$ 76,295,942	\$ 49,437,609	\$ 71,543,220	\$ 50,361,031	\$ 72,645,752	\$ 49,883,172
Israel	9,188,632	10,080,452	17,631,139	10,258,698	13,944,078	8,308,931
Canada.....	2,017,304	—	1,147,679	—	2,435,134	—
Taiwan.....	435,759	—	—	—	690,080	—
Mexico.....	1,549,703	—	2,528,220	—	590,919	—
Japan	—	—	770,439	—	182,996	—
Germany	397,527	—	226,806	—	115,509	—
Italy.....	435,470	—	204,147	—	—	—
Jordan	490,882	—	—	—	—	—
Indonesia.....	295,072	—	384,928	—	—	—
Singapore.....	989,631	—	336,896	—	—	—
Thailand	597,355	—	91,375	—	1,725	—
Costa Rica.....	437,866	—	—	—	—	—
China.....	550,179	—	2,214,436	—	—	—
Other	2,918,419	—	1,643,393	—	2,369,559	—
	<u>\$ 96,599,741</u>	<u>\$ 59,518,061</u>	<u>\$ 98,722,678</u>	<u>\$ 60,619,729</u>	<u>\$ 92,975,752</u>	<u>\$ 58,192,103</u>

AROTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 15:- WARRANTY

The following is a summary of the deferred warranty revenue in the Simulation Division included in total deferred revenue as of December 31, 2018 and 2017:

	Twelve months ended December 31,	
	2018	2017
Balance at beginning of period	\$ 3,387,771	\$ 2,702,615
Deferred revenue	4,585,355	3,864,556
Revenue recognized.....	(3,539,931)	(3,179,400)
Balance at end of period.....	<u>\$ 4,433,195</u>	<u>\$ 3,387,771</u>

The following is a summary of the warranty liability in the Power Systems Division that is also included in deferred revenue as of December 31, 2018 and 2017:

	Twelve months ended December 31,	
	2018	2017
Balance at beginning of period	\$ 176,953	\$ 202,429
New reserves.....	125,855	88,223
Costs incurred.....	(97,617)	(113,699)
Balance at end of period.....	<u>\$ 205,191</u>	<u>\$ 176,953</u>

NOTE 16:- QUARTERLY RESULTS OF OPERATIONS (UNAUDITED):

The unaudited quarterly information for the fiscal year 2017 has been restated to correct the error described in Note 3, "Restatement of Previously Issued Consolidated Financial Statements."

	Twelve months ended December 31, 2018			
(in thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues.....	\$ 27,249	\$ 21,875	\$ 23,844	\$ 23,632
Gross profit	7,712	6,600	7,327	7,559
Net income (loss).....	596	83	740	451
Basic net income/(loss) per common share	\$ 0.02	\$ -	\$ 0.03	\$ 0.02
Diluted net income/(loss) per common share.....	\$ 0.02	\$ -	\$ 0.03	\$ 0.02

	Twelve months ended December 31, 2017 (as reported)			
(in thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues.....	\$ 22,347	\$ 21,449	\$ 25,931	\$ 28,996
Gross profit	6,480	5,982	7,257	7,921
Net income (loss).....	(768)	(594)	787	4,409
Basic net income/(loss) per common share	\$ (0.03)	\$ (0.02)	\$ 0.03	\$ 0.17
Diluted net income/(loss) per common share.....	\$ (0.03)	\$ (0.02)	\$ 0.03	\$ 0.17

	Twelve months ended December 31, 2017 (as restated)			
(in thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter (as restated)
Revenues.....	\$ 22,347	\$ 21,449	\$ 25,931	\$ 28,996
Gross profit	6,480	5,982	7,257	7,921
Net income (loss)*	(768)	(594)	787	7,610
Basic net income/(loss) per common share	\$ (0.03)	\$ (0.02)	\$ 0.03	\$ 0.29
Diluted net income/(loss) per common share.....	\$ (0.03)	\$ (0.02)	\$ 0.03	\$ 0.29

*During the fourth quarter the Company recorded an additional income tax benefit of \$3.2 million due to a correction of an error, for a total of \$6.4 million in federal income tax benefit associated with the Tax Act. This resulted in an increase in basic and diluted earnings per share of \$0.12. See Note 3, "Restatement of Previously Issued Consolidated Financial Statements."

AROTECH DIRECTORS

Jon B. Kutler, Chairman of the Board
Chairman and CEO, Admiralty Partners, Inc.

Kenneth W. Cappell
Retired Partner, PricewaterhouseCoopers

Lawrence F. Hagenbuch
Managing Director, Huron Consulting

James J. Quinn
Rear Admiral, USN (Ret.)

AROTECH CORPORATE OFFICERS

Dean M. Krutty
President and CEO

Kelli L. Kellar
Vice President – Finance and CFO

Yaakov Har-Oz
Senior Vice President, General Counsel and Secretary

Colin Gallagher
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Monday, May 6, 2019, at 8:00 a.m. local time at the offices of the Company's subsidiary UEC Electronics LLC, 5916 Howard Street, Hanahan, South Carolina.

Stock Transfer Agent

American Stock Transfer & Trust Company, 6201 15th Avenue, Brooklyn, NY 11219.

Shares Traded

The stock of Arotech Corporation is traded on the Nasdaq Global Market under the symbol ARTX.

Forms 10-K

Our Annual Report on Form 10-K provides additional information and is on file with the Securities and Exchange Commission. It is available free of charge upon written request to Stockholder Relations, Arotech Corporation, 1229 Oak Valley Drive, Ann Arbor, Michigan 48108.

Website

Our corporate website is at <http://www.arotech.com>. Reference to our website does not constitute incorporation of any of the information thereon into this annual report.

TRAINING AND SIMULATION DIVISION

The Power to Visualize

Providing world-class simulation based solutions for training and research.



POWER SYSTEMS DIVISION

Complex Engineering Delivered. Simply.

Innovative design, rapid prototyping and lean manufacturing for aerospace, defense, medical and industrial applications worldwide.



AROTECH

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