Arotech Corporation

Leading products for military, homeland security, law enforcement and public safety requirements

Annual Report 2004

Nasdaq: ARTX

AROTECH

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Simulation and Security Division

Armor Division

Battery & Power Systems Division

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The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2005, as amended on May 2, 2005.

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.*

June 2005

Dear Fellow Shareholder,

2004 was a significant and successful year for Arotech. It was a year in which we transformed the company into an important vendor to the security and defense sector.

We accomplished this through a combination of internal growth and strategic acquisitions. We tripled our revenues compared to 2003 and achieved the goals that we set out for ourselves at the beginning of the year, which included, to become positive adjusted EBITDA in the second half of 2004 and for the full year. In addition, we established the necessary building blocks to be well positioned for continued growth in 2005.

During the year, we sharpened our focus and fortified our position in our three fields of expertise in which we have significant experience: Simulation and Security, Armor, and Battery and Power Systems.

We added three solid companies to our portfolio – one in each of these product areas. We acquired FAAC Incorporated and Epsilor Electronic Industries Ltd. at the beginning of the year, and Armour of America in August. These 3 new subsidiaries have expanded Arotech's customer base and footprint in the market and have enhanced the operations and operating results of their respective divisions.

Highlights of 2004:

Simulation and Security Division

The successful acquisition and integration of our military and commercial transit simulator business, FAAC, contributed dramatically to the division's growth in 2004. FAAC was chosen as the primary supplier of the US Army's Common Driver Training program, a multi-year program estimated at $60 to $100 million, that will unify all army driving training simulators and support driver training and tactical maneuvering for combat applications.

We expanded our commercial transit simulator footprint, highlighted by the delivery of the first full mission rail simulator to the MTA of Houston and received a strategic order from New York City Transit, NYCT, to develop a New York Subway simulator program.

At the beginning of 2005, we announced a new contract from the UK's leading public transport operator, First, representing London Bus, to deliver a full mission Right Hand Drive bus simulator. We subsequently established a local presence in the UK.

Our "use-of-force" simulators were shipped during the year to a variety of law enforcement agencies, including the German police and Federal Protective Services. Towards the end of the year, we launched MILO, an interactive presentation system that is an important training tool for all organizations involved in public safety.

We are currently working with a major U.S. fire department to develop our Incident Command Training, ICT, system that will promote both strategic and tactical training for firefighters as part of our focus on the rapidly growing first responder market. The ICT system will also provide training for incidents that involve multiple agencies such as fire departments, police, emergency medical organizations, military, utilities and others.

Armor Division

The Armor division experienced significant growth in 2004, which was highlighted by the delivery of a contract for over 100 armored Land Cruisers and Land Rovers to a private contractor in Iraq. Some of these vehicles actually came under attack, saving passengers' lives. The roll-out of this contract was supported by the establishment of our armoring plant in Auburn, Alabama, to support the growth in demand for our armored vehicle business.

Other armored shipments included the delivery of our 16-passenger buses to the US Army in Iraq, as well as our Land Rover Defender to US Agencies operating in Iraq and armored SuVs and vans to different customers in Israel.

In 2004, we delivered the first batch of the DAVID armored combat vehicle to the IDF. The DAVID is designed for operation in the limited conflict war zone, primarily in tight urban environments. Into 2005, we continue to witness significant interest in this vehicle and expect it to be an area of growth in the second half of the year.

In August, 2004, we acquired Armour of America, (AoA), an innovative supplier of personal ballistic armoring and a leading supplier of aircraft armoring. We have since delivered orders to a variety of customers, supplying rotary and fixed wing aircraft armor, vests, and military vehicle armor kits and blankets. AoA is currently pursuing a number of significant potential opportunities which we believe could bear fruit in the coming months.

Battery and Power Systems Division

The successful deployment of our BA 8180 zinc-air battery to CECOM, the U.S. Army's Communications and Electronics Command continued throughout 2004 and in 2005, we announced a new IDIQ CECOM contract for these batteries, valued at up to $24 million.

We received several noteworthy development contracts for our new fourth generation zinc-air battery, including funding from CECOM under a research program aimed at the Future Force Warrior. This new generation battery is well-suited to a variety of applications and is proving to be a most beneficial solution, particularly for the rapidly growing unmanned vehicle market where we have demonstrated the ability to extend mission durations.

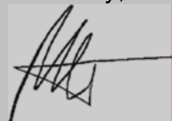
Our acquisition of Epsilor, a lithium battery and charger company focused on products for the military, contributed significantly to the division's growth in 2004. Recently, we expanded the capability of our Auburn battery facility to produce rechargeable batteries and chargers and have received our first orders. By coupling our zinc-air technology with our charger/electronics technology, we believe we are well-positioned to increase our market share in the military batteries market.

***Looking Ahead**:*

In 2005, in addition to fostering internal growth, we shall continue to focus on growth opportunities through strategic acquisitions which will significantly contribute to our operating results. Going forward, we are well-positioned to capture increased market share in this rapidly growing market. We look forward to reporting another year of substantial growth this year, in 2005.

On behalf of the entire Company, I would like to express our gratitude to our dedicated shareholders and I give you my assurance that we are working hard to increase our shareholders' value on an ongoing basis.

Sincerely,



Robert S. Ehrlich
Chairman, President and CEO

General

We are a defense and security products and services company, engaged in three business areas: high-level armoring for military, paramilitary and commercial air and ground vehicles; interactive simulation for military, law enforcement and commercial markets; and batteries and charging systems for the military. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate primarily as a holding company, through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned by us, unless otherwise noted) are as follows:

- We develop, manufacture and market advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement, security and other personnel through our ***Simulation and Security Division***:
  - We provide simulators, systems engineering and software products to the United States military, government and private industry through our subsidiary FAAC Incorporated, located in Ann Arbor, Michigan ("FAAC"); and
  - We provide specialized "use of force" training for police, security personnel and the military through our subsidiary IES Interactive Training, Inc., located in Littleton, Colorado ("IES").
- We manufacture aviation armor and we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles through our ***Armor Division***:
  - We manufacturer ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles and architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique vest that is certified by the U.S. Coast Guard, through our subsidiary Armour of America, located in Los Angeles, California, ("AoA"); and
  - We use state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs, through our subsidiaries MDT Protective Industries, Ltd., located in Lod, Israel ("MDT"), of which we own 75.5%, and MDT Armor Corporation, located in Auburn, Alabama ("MDT Armor"), of which we own 88%.
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles through our ***Battery and Power Systems Division***:
  - We develop and sell rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia through our subsidiary Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area) ("Epsilor");
  - We manufacture and sell Zinc-Air fuel cells, batteries and chargers for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama ("EFB"); and
  - We produce water-activated life-jacket lights for commercial aviation and marine applications, and we conduct our Electric Vehicle effort, through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel ("EFL").

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. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech's wholly-owned Israeli subsidiaries, EFL and Epsilor; Arotech's majority-owned Israeli subsidiaries, MDT and MDT Armor; and Arotech's wholly-owned United States subsidiaries, EFB, IES, FAAC and AoA.

For financial information concerning the business segments in which we operate, see Note 18 of the Notes to the Consolidated Financial Statements. For financial information about geographic areas in which we engage in business, see Note

18.c of the Notes to the Consolidated Financial Statements.

Facilities

Our principal executive offices have recently been re-located to EFB's premises at 354 Industry Drive, Auburn, Alabama 36830, and our telephone number at our executive offices is (334) 502-9001. Our corporate website is www.arotech.com. Our periodic reports to the Securities Exchange Commission, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at http://www.arotech.com/compro/investor.html, 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 three of our principal subsidiaries, EFL, MDT and Epsilor, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of the members of our senior management work extensively out of EFL's facilities. IES's offices and facilities are located in Littleton, Colorado, FAAC's home offices and facilities are located in Ann Arbor, Michigan, AoA's offices and facilities are located in Los Angeles, California, and the offices and facilities of EFB and MDT Armor are located in Auburn, Alabama.

Simulation and Security Division

We develop, manufacture and market advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement, security and other personnel through our Simulation and Security Division, the largest of our three divisions. During 2004, 2003 and 2002 revenues from our Simulation and Security Division were approximately $21.5 million, $8.0 million and $2.0 million, respectively (on a pro forma basis, assuming we had owned all components of our Simulation and Security Division since January 1, 2002, revenues in 2004, 2003 and 2002 would have been approximately $21.5 million, $17.9 million and $20.3 million, respectively).

Vehicle Simulators

We provide simulators, systems engineering and software products to the United States military, government and private industry through our wholly-owned subsidiary, FAAC Corporation, based in Ann Arbor, Michigan. 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 conscientious equipment operation. We have an installed base of over 220 simulators that have successfully trained over 100,000 drivers. Our customer base includes all branches of the U.S. Department of Defense, state and local governments, and commercial entities.

Introduction

We conduct our business in two primary areas: Vehicle Simulations, which focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles – for commercial, governmental and foreign customers; and Military Operations, which conducts tactical air and land combat analysis and develops analytical models, simulations, and “turnkey” training systems for the U.S. military. In 2004, Vehicle Simulations accounted for approximately 80% of our vehicle simulation revenues, and Military Operations accounted for approximately 20% of our vehicle simulation revenues.

In the area of Military Operations, we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare for all branches of the Department of Defense and its related industrial contractors. Our simulations are found in systems ranging from instrumented air combat and maneuver ranges (such as Top Gun) to full task training devices such as the F-18 Weapon Tactics Trainer. We are also the leading supplier of wheeled vehicle simulators to the U.S. Armed Forces for mission-critical vehicle training.

We supply on-board software to support weapon launch decisions for the F-15, F-18, and Joint Strike Fighter (JSF) fighter aircraft. Pilots benefit by having highly accurate presentations of their weapon's capabilities, including susceptibility to target defensive reactions. We designed and developed an instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system. The special operational forces aircrew training system provides a full range of aircrew training, including

initial qualification, mission qualification, continuation, and upgrade training, as well as combat mission rehearsal.

Simulators are cost-effective solutions, enabling users to reduce overall aircraft and ground vehicle usage, vehicle maintenance costs, fuel costs, repairs, and spares expenditures. For example, our Medium Tactical Vehicle Replacement (MTVR) simulators have reduced total driver training time by 35%. Many customers have reduced actual “behind-the-wheel” time by up to 50% while still maintaining or improving safety. Additionally, for customers with multiple simulators, the corresponding increase in the student to instructor ratio has reduced instructor cost per student.

The implementation of our vehicle simulators has led to measurable benefits. North American Van Lines, one of our earliest vehicle simulator customers, has shown a 22% reduction in preventable accidents since it began using our simulators. The German Army, one of our earliest Military Vehicle customers, showed better driver testing scores in 14 of 18 driver skills compared to classroom and live driver training results. Additionally, the New York City Transit Authority documented a 43% reduction in preventable accidents over its first six months of use and has reduced its driver hiring and training “washout” by 50%.

Simulators can produce more drastic situations than can traditional training, which inherently produces drivers that are more skilled in diverse driving conditions. For example, while many first-time drivers will learn to drive during the summer months, they are not trained to drive in wintry conditions. Simulators can produce these and other situations, such as a tire blowout or having to react to a driver cutting off the trainee, effectively preparing the driver for adverse conditions.

We believe that we have held a 100% market share in U.S. military wheeled simulators since 1999 and hold a market share in excess of 50% in U.S. commercial wheeled vehicle simulators.

PRODUCT LINES

Below is a description of our vehicle simulator products and product lines.

Vehicle Simulations

Military Vehicles

Military Vehicles comprise the majority of our vehicle simulation business. Military vehicle simulators are highly realistic vehicle simulators that include variable reactive traffic and road conditions, the capacity to customize driving conditions to be geography-specific, and training in hazardous and emergency conditions. We have several large contracts and task orders in the Military Vehicles business, including (i) the MTVR contract to develop vehicle simulators and related training services for the U.S. Marine Corps; (ii) a series of scheduled General Services Administration purchases of simulators with the U.S. Army to supply 78 simulators for 25 training sites; (iii) a two-year contract with the U.S. Navy Seabees to supply eight simulators for three training sites; and (iv) a ten-year, task order contract to develop a series of Common Driver Trainers for the U.S. Army, the first task order of which is for nine Stryker simulators. We estimate that our software trained 12,000 soldiers at ten sites in 2004.

Our military vehicle simulators provide complete training capabilities, based on integrated, effective simulation solutions, to military vehicle operators in the U.S. Armed Forces. Our flagship military vehicle simulation product is our MTVR Operator Driver Simulator, developed for the USMC. The MTVR ODS concept is centered on a pod of up to six Student Training Stations (STS) and a single controlling Instructor Operator Station (IOS). The STS realistically simulates the form, fit, and feel of the MTVR vehicle. The high-fidelity version of the STS consists of a modified production cab unit mounted on a full six-degree-of-freedom motion platform. The STS provides a field of view of over 180-degrees into a realistically depicted virtual world, simulating a variety of on-road and off-road conditions. The IOS is the main simulation control point supporting the instructor’s role in simulator training. The IOS initializes and configures the attached STS, conducts training scenarios, assesses student performance, and maintains scenarios and approved curriculum.

Our software solution provides a complete operator training curriculum based upon integrated simulation training. Military vehicle simulators enable students to learn proper operational techniques under all terrain, weather, road, and traffic conditions. Instructors can use simulators as the primary instructional device, quantitatively evaluating student performance under controlled, repeatable scenarios. This monitoring, combined with the ability to create hazardous and potentially dangerous situations without risk to man or material, results in well-trained students at significantly less cost than through the use of traditional training techniques.

In addition to standard on-road driver training, our military vehicle simulators can provide training in such tasks as:

- Off-road driving on severe slopes, including muddy or swampy terrain;
- Night vision goggle and blackout conditions;
- Convoy training; and
- The use of the Central Tire Inflation System in response to changing terrain.

In addition to simulation systems, we offer on-site operator and maintenance staff, train-the-trainer courses, curriculum development, scenario development, system maintenance, software upgrades, and warranty packages to our U.S. Armed Forces customers.

Commercial Vehicles

The Commercial Vehicles business is comprised of technology similar to that of the Military Vehicles product line and also is customized to reflect the specific vehicle being simulated. We serve four primary customer bases in the Commercial Vehicles business: transit, municipal, airport, and corporate customers.

Transit

Transit customers represent an attractive customer base as they generally have access to their own funds, which often exempts them from the lengthy and complex process of requesting funds from a governing body. We have provided bus simulators to fourteen leading transit authorities, including the New York City Transit Authority, Washington, D.C. Metro, Dallas Area Rapid Transit, and the Chicago Transit Authority. We have also provided a rail simulator to Houston Metro and we were competitively awarded a major rail simulator program with New York City Transit.

Municipal

We target municipal customers in police departments, hospitals, fire departments, and departments of transportation for sales of our municipal product. Our customers include the Mexico Department of Education, California Department of Transportation, and the Fire Department of New York. We are developing an industry advisory group focusing on the municipal market to identify and address customer needs. Additionally, we have developed a simulator module to extend the simulation once police, fire, or emergency medical service personnel reach the incident location. We believe that this represents another of our bases of differentiation over our competition.

Airport

We were a pioneer in providing simulation software to airports to facilitate training personnel in adverse conditions, including the Detroit and Toronto airports.

Corporate

We target corporate fleets and "for-hire" haulers as customers of the corporate simulator product. These customers use simulators to train personnel effectively as well as to avoid the brand damage that could be associated with poor driver performance. To date, we have provided simulators to customers such as Schlumberger Oil Services, Kramer Entertainment, and North American Van Lines.

Military Operations

We provide air combat range software, missile launch envelope decision support software, the SimBuilder™ simulation software product, and Weapon System Trainer software through the Military Operations business line.

Air Combat Range Software

We serve the U.S. Air Force Air Combat Training System and U.S. Navy Tactical Aircrew Training System with our air combat training range software. Air combat training ranges allow pilots to train and evaluate new tactics in a controlled airborne environment. Air "battles" are extremely realistic, with our software determining the outcome of weapon engagements based on launch conditions and the target aircraft defensive reactions.

Missile Launch Envelope Software

Onboard weapon decision-making software enables pilots to assimilate the complex information presented to them in F-15, F-18 and Joint Strike Fighter (JSF) fighter aircraft. We provide our missile launch envelope software to the U.S. Navy and Air Force through our subcontracting relationships with Boeing and Raytheon.

Weapon System Trainer Software

We have successfully transitioned software from U.S. Navy Tactical Aircrew Training Systems to over 15 Weapon Systems Trainers built by prime contractors such as L-3, Boeing, Northrop Grumman, and Lockheed Martin.

SIMBuilder™

The SimBuilder™ simulation software product is designed to provide weapons simulation models for use in training environments for launched weapons. This software enables foreign end-users to use weapons simulation models similar to the U.S. military without classified U.S. weapons data. Militaries of Australia, the United Arab Emirates, Canada, Taiwan, and Singapore currently use SimBuilders™.

Use-of-Force Training

We are a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, security, military and similar applications. With a customer base of over 700 customers in over twenty countries around the world, we are a leader in the supply of simulation training products to military, law enforcement and corporate client communities. We believe, based on our general knowledge of the size of the interactive use-of-force market, our specific knowledge of the extent of our sales, and discussions we have held with customers at trade shows, etc., that we provide more than 35% of the worldwide market for government and military judgment training simulators. We conduct our interactive training activities through our subsidiary IES Interactive Training, Inc. (“IES”), a Delaware corporation based in Littleton, Colorado.

INTRODUCTION

We offer consumers the following interactive training products and services:

- *Range 3000* – providing use-of-force simulation for military and law enforcement. We believe that the Range 3000 is the most technologically advanced judgment training simulator in the world.
- *A2Z Classroom Trainer* – a state-of-the-art computer based training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom.
- *Range FDU (Firearms Diagnostic Unit)* – a unique combination of training and interactive technologies that give instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.
- *Milo (Multiple Interactive Learning/training Objectives)* – a simulator designed with “plug in” modules to customize the training system to meet end user needs.
- *Summit Training International* – providing relevant, cost-effective professional training services and interactive courseware for law enforcement, corrections and corporate clients.
- *IES Studio Productions* – providing cutting edge multimedia video services for law enforcement, military and security agencies, utilizing the newest equipment to create the training services required by the most demanding authorities.

Our products feature state of the art all digital video formats, ultra-advanced laser-based lane detection for optimal accuracy and performance, customer-based authoring of training scenarios, and 95% COTS (commercial off-the-shelf)-based system.

PRODUCTS

Below is a description of each of the core products and services in the IES line.

Range 3000 “Use of Force” Simulator

We believe that the Range 3000, which was launched in late 2002, combines the most powerful operational hardware and software available, and delivers performance unobtainable by any competing product presently on the market.

The Range 3000 simulator allows training with respect to the full “Use of Force” continuum. Training can be done on an individual basis, or as many as four members of a team can participate simultaneously and be scored and recorded individually. Topics of training include (but are not limited to):

- *Officer’s Presence and Demeanor* – Picture-on-picture digital recordings of the trainee’s actions allows visual review of the trainee’s reaction, body language and weapons handling during the course of the scenario, which then can be played back for debriefing of the trainee’s actions.
- *Verbalization* – Correct phrases, timing, manner and sequence of an officer’s dialogue is integrated within the platform of the system, allowing the situation to escalate or de-escalate through the officer’s own words in the context of the scenario and in conjunction with the trainer.
- *Less-Than-Lethal Training* – Training in the use of non-lethal devices such as Taser, OC (pepper spray), batons and other devices

can be used with the video training scenarios with appropriate reactions of each.

- *Soft Hand Tactics* – Low level physical control tactics with the use of additional equipment such as take-down dummies can be used.
- *Firearms Training and Basic Marksmanship* – Either utilizing laser based training weapons or in conjunction with a live-fire screen, the use of "Live Ammunition" training can be employed on the system.

The interactive training scenarios are projected either through single or multiple screens and projectors, allowing us to immerse a trainee in true-to-life training scenarios and incorporating one or all the above training issues in the "Use of Force" continuum.

A2Z Classroom Trainer

The A2Z is a state-of-the-art Computer Based Training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom.

Using individual hand-held keypads, the students can answer true/false or multiple choice questions. Based on the student's performance, the scenario will branch and unfold to a virtually unlimited variety of different possible outcomes of the student's actions. The system logs and automatically scores each and every trainee's response and answer. At the end of the scenario, the system displays a session results summary from which the trainer can debrief the class.

The advanced A2Z Courseware Authoring Tools allow the trainer easily to create complete customized interactive courses and scenarios.

The Authoring Tools harness advances in digital video and multimedia, allowing the trainer to capture video and graphics from any source. The A2Z allows the trainer to combine his or her insight, experience and skills to recreate a realistic learning environment. The A2Z Training System is based on the well-known PC-Pentium technology and Windows XP™ operated. The menu and mouse operation make the A2Z user-friendly.

The individual keypads are connected "wirelessly." The system is completely portable and may be setup within a matter of minutes.

Key advantages:

- Provides repeatable training to a standard based on established policy
- Quick dissemination and reinforcement of correct behavior and policies
- Helps reduce liability
- More efficient than "traditional and redundant" role-playing methods
- Realistic scenarios instead of outdated "play-acting"
- Interactive training of up to 250 students simultaneously with wireless keypads
- Easy Self-Authoring of interactive training content
- PC-Pentium platform facilitates low cost of ownership
- Easy to use Windows XP-based software
- Easy to deploy in any classroom

Range FDU

The Range FDU (firearm diagnostics unit) is a unique combination of training and interactive technologies that gives instructors a first-person perspective of what trainees are seeing and doing when firing a weapon. The Range FDU is the only firearms training technology of its kind.

With the Range FDU, firearms instructors can see the trainees' actual sight alignment to the target as well as measure trigger pressure against proper trigger pressure graphs, making corrective instruction simple and effective. In addition, the Range FDU records a trainee's recoil control, grip and stance – allowing the instructor to playback the information in slow motion or real time to better analyze the trainee's actions and more accurately diagnose any deficiencies.

The Range FDU also has the ability to record the firearm instruction session to either DVD or VHS, allowing both the trainee and the instructor to review it at a later time. Trainees now have a diagnostic tool that they can learn from, even after their training has been completed. In addition, instructors can build a library for each trainee to record progress.

The Range FDU provides the following benefits:

- Fall of shot feedback
- Trigger pressure analysis
- Recoil control, grip and stance assessment

- Sight alignment
- Sight picture analysis and target reacquisition

Milo

Milo (Multiple Interactive Learning/training Objectives) is a simulator designed with “plug in” modules to customize the trainings system to meet end user needs, and is designed to expand the market for sales of our IES products to include organizations involved in all aspects of public safety, and not just law enforcement.

Professional Conferences and Courseware

We provide relevant, cost-effective professional training seminars, consulting services, and interactive courseware for law enforcement, corrections, and corporate clients through Summit Training International (STI), a wholly-owned subsidiary of IES. The emphasis and goal of our conferences and courseware is to create a “total training” environment designed to address the cutting edge issues faced today. We provide conferences throughout the United States, and develop courseware dealing with these important topics. The incorporation of IES Interactive Systems in our conferences creates an intense learning environment and adds to the realism of the trainee’s experience.

Conferences

We have provided conferences throughout the United States, on such topics as:

- Recruiting and Retention of Law Enforcement and Corrections Personnel
- Ethics and Integrity
- Issues of Hate Crimes
- Traffic Stops and Use of Force
- Community and Corporate Partnerships for Public Safety
- Creating a Safe School Environment

In addition to these national and regional conferences, we design and produce training to address specific department issues. We have a distinguished cadre of instructors that allows adaptation of programs to make them specifically focused for a more intense learning experience. The A2Z Classroom Trainer is incorporated into the “live” presentation creating a stimulating interactive training experience.

Courseware

We develop courseware for use exclusively with IES’s interactive systems. Courses are designed to addresses specific department issues, and can be customized to fit each agency’s needs. These courses are available in boxed sets that provide the customer with a turn-key training session. The A2Z Classroom Trainer and the Range 3000 XP-4 are used to deliver the curriculum and create a virtual world that the trainees respond and react to. Strategic relationships with high profile companies such as H&K Firearms, and Taser International, provide customers with training that deals with cutting edge issues facing law enforcement today. The incorporation of our courseware library along with simulation systems allows training to remain consistent and effective, giving customers more value for their training dollar.

IES Studio Productions

Through IES Studio Productions, a division of IES, we provide multimedia video services for law enforcement, military and security agencies, and others and create interactive courseware and interactive scenarios for the Range 3000, Video Training Scenarios and all types of video production services. With the latest in media equipment, we provide all media and marketing services to IES Interactive Training in-house.

Armor Division

We manufacture aviation and other armor and we armor vehicles through our Armor Division. During 2004, 2003 and 2002 revenues from our Armor Division were approximately $18.0 million, $3.4 million and $2.7 million, respectively (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2002, revenues in 2004, 2003 and 2002 would have been approximately $29.2 million, $10.9 million and $13.3 million, respectively).

Aircraft Armoring

INTRODUCTION

We are an innovative manufacturer of lightweight personal, vehicle, aviation, architectural and marine ballistic armoring. Our Armor Division has years of battlefield and commercial protection experience and has provided life saving protection under the most extreme conditions. Through our subsidiary Armour of America, located in Los Angeles, California, we manufacturer ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles, architectural applications, including both

the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique armored floatation vest that is certified by the U.S. Coast Guard.

For over thirty years, AoA has delivered ballistic armor equipment to users worldwide. Initially, AoA designed and manufactured "soft" ballistic armor only, such as covert and overt ballistic vests, military assault vests, tactical vests and specially designed vests for military and law enforcement users both in the U.S. and abroad. By 1982, AoA had started to design and manufacture "hard" ballistic armor to stop military rifle fire up to and including .50 caliber Armor Piercing Incendiary (API) and European 12.7 mm API rounds. This "hard" ballistic armor is used as chest protection for the full line of personal vests, as well as on fixed wing aircraft (airplanes) and rotary wing aircraft (helicopters), military ships, military vehicles and architectural applications.

Our proprietary designs have been developed to meet a wide variety of customer and industry needs.

The Armoring Process

Each hard armor kit starts out with detailed templates generated at the aircraft or vehicle, with close fitting around pedals, consoles and other obstructions. These templates are converted into wood patterns that are exact three-dimensional reproductions of the armor to be manufactured, including as to the thickness. These patterns are fitted back into the user's aircraft or vehicle and approved. At this point, fiberglass over wood production molds are produced for each part, which will guarantee that each production panel will be exactly the same and fit perfectly within the kit. In addition, each kit has a complete set of installation hardware that includes everything required to install the armor kit to the aircraft or vehicle. This total kit package allows the armor to be installed at any location with a minimum of tools required.

Soft armor is manufactured in the same manner as hard armor. Detailed cut and sew patterns are developed from the requirements driven by the customer. These requirements are normally dealing with collar height, placement of pockets and location of plate pockets. Once these patterns are completed, two processes start simultaneously. The first involves spreading multiple plies of ballistic material on a special cutting table. The material is then dusted with pattern powder to mark the packs for cutting. After each pack is cut to size, it is routed to the sew shop for stitching. At the same time, nylon covers are being cut and sewn using sew patterns made from the cut patterns. Upon completion of both the ballistic pack and the cover, the pack is inserted into the cover and sewn closed.

Product Lines

We produce two kinds of armor, soft armor and hard armor, to support customer armor requirements. Soft armor, which is capable of protecting against all handguns and 9mm sub guns, is used in our ballistic and fragmentation vest, military vehicle, marine, architectural and special application armor lines. Hard armor, which is capable of protecting against rifle fire up to 50cal/12.7mm API, is used in our ballistic chest plate, aircraft, military vehicle, marine and architectural armor lines. Within these two basic kinds of armor, we offer the product lines listed below.

Fixed and Rotary Wing Aircraft Armor Systems

We design and manufacture ballistic armor systems for a wide variety of fixed and rotary wing aircraft. These systems are in the form of kits, with individual contoured panels which cover the entire aircraft's floor, walls, seats, bulkheads, walls, oxygen containers, avionics and doors. All of our ballistic armor kits include a complete installation hardware kit containing all items required for installation. The supplied hardware is designed for each individual application in accordance with the installation hardware certification, which has been provided by Lockheed-Martin. Additionally, the fixed and rotary wing aircraft kits have been certified, by an independent test facility that is approved by the FAA, to meet flammability requirements of FAA/FAR 25.853, 12 Second Vertical Test and MIL-STD-810 Environmental Testing.

These kits have been sold to both the original airframe manufacturers and end users worldwide. Armor kits for rotary wing aircraft including Bell Helicopter's B206, B212, B407, B412, B427, and UH-1H; Boeing's CH-46 and CH-47; MD Helicopter's MD 500, MD 600, and MD 900; Agusta Helicopter's A109; Eurocopter's EC-120, EC-135, BK117, and BO-105; Aerospatiale's AS 330, AS 332, and AS 355; Sikorsky's UH-60 and S-61; MIL MI-8 and MI-17; Robinson's R-22 and R-44; and Kaman's K-MAX.

Fixed wing aircraft kits include Lockheed's C-130H, C-130J , and P-3; Boeing's C-17; Alenia's G-222 and C-27J; Ayers' T-65; Rockwell's OV-10; CASA CN 235 and CN 295; and special configurations of the Citation, Beechcraft and Cessna models.

Military Vehicles Armor Kits

For the military vehicle market, we provide ballistic armor kits to protect against fragmentation and rifle fire, up to 50cal API for Humvees, 2½- and 5-ton trucks, HEMTT wreckers and various construction vehicles. These kits offer varying levels of protection for doors, floors, fuel tanks, air bottles, cargo beds, troop seat backs, critical components and glass. To date, we have protected vehicles deployed in Iraq, Afghanistan, and Kuwait. All of the provided kits are designed for easy field level installation and include required hardware and instructions.

Marine Armor Kits

For the marine market, we manufacture armor kits for the gun mounts on naval ships and riverine patrol boats. During Operation Desert Storm, we designed and manufactured .50 cal AP ballistic panels and deck mount brackets for the U.S. Navy. Since then, we have designed and manufactured armor to fit both the .50 cal and 25mm gun mounts on frigates, destroyers, cruisers and aircraft carriers. The result of this effort is that we have delivered armor systems to individual ships in the class and currently are pursuing armoring additional classes of ships throughout the Navy Command.

Additionally, we have designed program-specific armor for riverine and small boats throughout the world. While the majority of these armoring programs were limited to a small number of boats, the areas of coverage included complete coverage of the exterior walls of the wheel house, forward and aft gun placements, fire boxes, fuel tanks and engines. Unlike designing armor kits for aircraft, this type of armoring requires unique installation methods to allow for interference caused by surface mounted hardware and the impact of "green water" impacting the armor during rough weather.

Ballistic Vests and Plates and Body Armor

We manufacture a complete line of personal body armor, including concealable, external and special application armor. The concealable armor vest offers complete front, side and back protection using soft, lightweight, high strength proprietary woven ballistic fabrics.

Our external vest line includes assault, tactical, riot, stab and T-panel designs. Each of these designs can be modified to meet the individual wearer of customer's requirements. Special application vests include the Armourfloat, which to our knowledge is currently the only ballistic/floatation vest approved by the U.S. Coast Guard; the Zip Out armor jacket, which offers covert protection in both a lightweight jacket or vest design; and our helicopter vest, which incorporates a unique protection/comfort design.

We offer a complete line of personal body armor including concealable ballistic vests, military vests and external tactical vests as well as a line of products specially designed for U.S. Navy Seal Teams and various law enforcement agencies in the United States and overseas. Our hard ballistic armor, designed to stop military rifle fire up to and including .50 caliber and European 12.7 mm Armor Piercing Incendiary (API) rounds, is used primarily on fixed and rotary wing aircraft, military ships and military vehicles, as well as in architectural applications.

We have designed and manufactured special operations personal armor including ballistic hand held shields and the LEGUARD® Tactical Leg Armor, which offers complete front protection for the lower thigh, knee, shin and instep.

Other Armor for Specialty Applications

In addition to aircraft, marine, vehicle and vest armor, we also manufacture ballistic and fragmentation blankets and curtains for numerous specialty applications. These applications include operator protection around test equipment; rupture protection of pressure vessels, mechanical failure of production machinery and high pressure piping. Additionally, we have supplied armor for office use in protection of occupants from blast and glass fragments of windows and isolation of security rooms from surrounding environments.

Vehicle Armoring

INTRODUCTION

We specialize in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs through our majority-owned subsidiaries, MDT Protective Industries Ltd., located in Lod, Israel, and MDT Armor Corporation, located in Auburn, Alabama. We are a leading supplier to the Israeli military, Israeli special forces and special services. Our products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide.

We have acquired many years of battlefield experience in Israel. Our vehicles have provided

proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings. In fact, to our knowledge an MDT-armored vehicle has never experienced bullet penetration into a vehicle cabin under attack. We also use our technology to protect vehicles against vandalism.

In 2003, we established MDT Armor's operations in a new facility in Auburn, Alabama. Soon thereafter, the United States General Services Administration (GSA) awarded us a five-year contract for vehicle armoring, establishing a pricing schedule for armoring of GM Suburban and Toyota Land Cruiser SUVs and of GM Savana/Express passenger vans. With this contract, these armored vehicles became available for purchase directly by all federal agencies beginning December 1, 2003, and we received our first U.S. orders for vehicle armoring products during 2004.

The Armoring Process

Armoring a vehicle involves much more than just adding "armor plates." It includes professional and secure installation of a variety of armor components – inside doors, behind dashboards, and all other areas of passenger and engine compartments. We use overlapping sections to ensure protection from all angles, and install armored glass in the windshield and windows. We have developed certain unique features, such as new window operation mechanisms that can raise windows rapidly despite their increased weight, gun ports, run-flat tires, and more. We developed the majority of the materials that we use in-house or in conjunction with Israeli companies specializing in protective materials.

In order to armor a vehicle, we first disassemble the vehicle and remove the interior paneling, passenger seats, doors, windows, etc. We then fortify the entire body of the vehicle, including the walls, pillars, floors, roof and other critical components, and reinforce the door hinges. We achieve firewall protection from frontal assault with carefully designed overlapping armor. Options, such as air-conditioning, seating modifications and run-flat tires, are also available. We fix the armoring into the shell of the vehicle, ensuring that the installation and finishing is according to the standards set for that particular model. We then reassemble the vehicle as close to its original appearance as possible.

Once we have ensured full vehicle protection, we place a premium on retaining the original vehicle's look and feel to the extent possible, including enabling full serviceability of the vehicle, thereby rendering the armoring process "invisible." We work with our customers to understand their requirements, and together with the customer develop an optimized armoring solution. A flexible design-to-cost process helps evaluate tradeoffs between heavy and light materials and various levels of protection.

By working within the vehicle manufacturer's specifications, we maintain stability, handling, center-of-gravity and overall integrity. Our methods minimize impact on payload, and do not obstruct the driver's or passengers' views. In many cases all the original warranties provided by the manufacturer are still in effect.

Armoring Materials

We offer a variety of armoring materials, optimized to the customer's requirements. We use ballistic steel, composite materials (including Kevlar®, Dyneema® and composite armor steel) as well as special ceramics, together with special armored glass. We use advanced engineering techniques and "light" composite materials, and avoid, to the extent possible, using traditional "heavy" materials such as armored steel because of the added weight, which impairs the driving performance and handling of the vehicle. We also sell certain kinds of vehicles pre-armored.

All materials that we use meet not only international ballistic standards, but also the far more stringent requirements set down by the Israeli military, the Israeli Ministries of Defense and Transport, and the Israel Standards Institute. Our facilities have also been granted the ISO 9001:200 quality standards award.

Products and Services

We armor a variety of vehicles for both commercial and military markets.

In the military market, we armor:

- The David, an Ultra Light Armored Vehicle based on a Land Rover or Mercedes platform;
- Command vehicles (such as the Land Rover Defender 110); and
- Pickup trucks such as the Defender 130.

In the commercial market, we armor:

- Sports utility vehicles (such as the GM Suburban, the Toyota Land Cruiser and the Land Rover Defender);
- Trucks, such as the Ford F550;

- Passenger vans (such as the Chevrolet Express, the General Motors Savana and the Ford Econoline); and
- Small buses (based on vehicles in the Mercedes-Benz Vario and Sprinter lines).

In 2004, we began to purchase some types of vehicles and armor them in order to be able to sell pre-armored vehicles.

Battery and Power Systems Division

We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles through our Battery and Power Systems Division. During 2004, 2003 and 2002 revenues from our Battery and Power Systems Division were approximately $10.5 million, $5.9 million and $1.7 million, respectively (on a pro forma basis, assuming we had owned all components of our Battery and Power Systems Division since January 1, 2002, revenues in 2004, 2003 and 2002 would have been approximately $10.5 million, $10.8 million and $6.5 million, respectively).

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

We sell lithium batteries and charging systems to the military through our subsidiary Epsilor Electronic Industries, Ltd., an Israeli corporation established in 1985 that we purchased early in 2004.

We specialize in the design and manufacture of primary and rechargeable batteries, related electronic circuits and associated chargers for military applications. 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 intend to work to open a lithium battery production, research and development, and marketing facility at our current Auburn premises. The goal is to penetrate the military lithium battery market in the United States, and also enable U.S.-produced lithium batteries to be sold using funding from the Foreign Military Sales (FMS) program to countries such as Israel and Turkey. To facilitate this technology transfer, we have hired Graydon C. Hansen, a seasoned battery industry executive, to preside over the complete Auburn facility.

PRODUCTS

We currently produce over 50 different products in the following categories:

- Primary batteries;
- Rechargeable batteries;
- Smart chargers;
- State of charge indicators; and
- Control and monitoring battery circuits.

Our lithium batteries are based on commercially-available battery cells that we purchase from several leading suppliers, with proprietary energy management circuitry and software. Our battery packs are designed to withstand harsh environments, and have a track record of years of service in armies worldwide.

We produce a wide range of primary batteries based on the following chemistries: lithium sulfur dioxide, lithium manganese dioxide and alkaline. The rechargeable battery chemistries that we employ are: nickel cadmium, nickel metal hydride and lithium-ion. We manufacture single and multi-channel smart chargers for nickel cadmium, nickel metal hydride and lithium-ion batteries.

We have designed a number of sophisticated state of charge indicators. These are employed in our Epsilor products and are also sold as components to other battery pack manufacturers. We also develop and manufacture control systems for high rate primary battery-packs and monitoring systems for rechargeable battery-packs.

Zinc-Air Fuel Cells, Batteries and Chargers for the Military

INTRODUCTION

We base our strategy in the field of Zinc-Air military batteries on the development and commercialization of our Zinc-Air fuel cell technology, as applied in the batteries we produce for the U.S. Army's Communications and Electronics Command (CECOM) through our subsidiary Electric Fuel Battery Corporation. We will continue to seek new applications for our technology in defense projects, wherever synergistic technology and business benefits may exist. We intend to continue to develop our battery products for defense agencies, and plan to sell our products either directly to such agencies or through prime contractors. We will also look to extend our reach to military markets outside the United States.

Since 1998 we have received and performed a series of contracts from CECOM to develop and

evaluate advanced primary Zinc-Air fuel cell packs. Pursuant to these contracts, we developed and began selling in 2002 a 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, weighs only six pounds and has approximately twice the energy capacity per pound of the U.S. Army's standard lithium-sulfur dioxide battery packs – the BA-8180/U battery.

In the second half of 2002, our five-year program with CECOM to develop a Zinc-Air battery for battlefield power culminated in the assignment of a National Stock Number and a $2.5 million delivery order for the newly designated BA-8180/U battery. Subsequent to this initial $2.5 million delivery order, we received additional follow-on orders from the Army.

Our batteries have been used in both Afghanistan (Operation Enduring Freedom) and in Iraq (Operation Iraqi Freedom). In June of 2004, our BA-8180 Zinc-Air battery was recognized by the U.S Army Research, Development and Engineering Command as one of the top ten inventions of 2003.

Our Zinc-Air fuel cells, batteries and chargers for the military are manufactured through our Electric Fuel Battery Corporation subsidiary. In 2003, our EFB facilities were granted ISO 9001 "Top Quality Standard" certification.

PRODUCTS

Zinc-Air Power Packs

BA-8180/U

Electric Fuel Zinc-Air power packs are lightweight, low-cost primary Zinc-Air batteries with up to twice the energy capacity per pound of primary lithium ($LiSO_2$) battery packs, which are the most popular batteries used in the US military today. Zinc-Air batteries are inherently safe in storage, transportation, use, and disposal.

The BA-8180/U is a 12/24 volt, 800 watt-hour battery pack approximately the size and weight of a notebook computer. The battery is based on a new generation of lightweight, 30 ampere-hour cells developed by us over the last five years with partial funding by CECOM. Each BA-8180/U battery pack contains 24 cells.

The battery has specific energy of up to 350 Wh/kg, which is substantially higher than that of any competing disposable battery available to the defense and security industries. By way of comparison, the BA-5590, a popular $LiSO_2$ battery pack, has only 175 Wh/kg. Specific energy, or energy capacity per unit of weight, translates into longer operating times for battery-powered electronic equipment, and greater portability as well. Because of lower cost per watt-hour, the BA-8180/U can provide substantial cost savings to the Army when deployed for longer missions, even for applications that are not man-portable.

CECOM has assigned a National Stock Number (NSN) to our Zinc-Air battery, making it possible to order and stock the battery for use by the Armed Forces. CECOM also assigned the designation BA-8180/U to our Zinc-Air battery, the first time an official US Army battery designation was ever assigned to a Zinc-Air battery.

Based on extensive contacts with the US and foreign military agencies, we believe that a significant market exists for the BA-8180/U both in the US Armed Forces and abroad.

BA-8140/U

The BA-8140/U is a new product that is presently being qualified and that has begun to generate initial sales. The BA-8140/U is a smaller version of our 8180/U, which we developed at the request of CECOM. It is approximately half the size, weight and capacity of our 8180/U, and is appropriate for smaller hand-held communications devices.

Adapters

The BA-8180/U is a battery, but in order to connect it or the 8140/U to a specific piece of equipment, an adapter must be used. In order to provide compatibility between the battery and various items of military equipment, we supply various types of electrical interface adapters for the BA-8180/U and the 8140/U, including equipment-specific adapters for the AN/PRC-119 SINCGARS and SINCGARS ASIP tactical radio sets, and a generic interface for items of equipment that were designed to interface with a BA-5590 or equivalent battery. Each of the three interfaces was also assigned a national stock number (NSN) by CECOM. In addition, we are in the process of adding four more electrical interfaces. These will address various applications, including other radios, night vision, missile launchers and chemical detectors.

Hybrids

We have also developed interface adapters for other items of equipment which require higher power than the BA-8180/U can provide by itself. For example, we have developed a hybrid battery system comprising a BA-8180/U battery pack and

two small rechargeable lead-acid packs. Even with the weight of the lead-acid batteries, this hybrid system powers a satellite communications terminal for significantly longer than an equivalent weight of BA-5590 $LiSO_2$ battery packs. We have also developed a hybrid system that incorporates ultracapacitors.

Forward Field Chargers

One of the initial goals to develop high energy density and power density Zinc-Air batteries was to deploy them as forward field chargers. It was envisioned that a man portable power pack would be required by the dismounted soldier to charge the range of rechargeable batteries now proliferating in the military. A high efficiency forward field charger has been developed which enables either a BB-390/U (NiMH) or a BB-2590/U (Li-ion) to receive multiple charges from a single BA-8180/U. We are also in the process of developing a forward field charger for the CSEL survival radio.

Other Zinc-Air Products

A fourth generation of Zinc-Air products is being developed for applications where volume is critical, and/or where the power to energy ratio needs to be significantly higher than that of the BA-8180/U. These "Gen4" Zinc-Air products consist of an air cathode folded around a zinc electrode. Gen4 was originally developed for the Marine Corps Dragon Eye UAV, which requires up to 200 W from a battery that fits into its sleek fuselage and which weighs less than one kilogram. Along the way, it was recognized that the Gen4 design could be applied to other battery missions requiring high power as well as energy density, such as Land Warrior and Objective Force Warrior soldier systems, where up to 300 Wh of energy are required of a 24 hour battery that must be worn conformably, at minimal weight. For these systems the battery currently limits functionality, and Gen4 zinc-air may be the enabling technology. During 2004, we were awarded $1 million of congressional funds and CECOM funding for the first phase of a three-phase BAA (Broad Agency Announcement, which is a simplified form of government solicitation for basic research and development) to develop this technology.

We are currently under contract, the second of its kind, with a U.S. agency, and a multi-year program with an Israeli security agency, to demonstrate the feasibility of Zinc-Air batteries for both unmanned aerial vehicles (UAV) and micro-air vehicles (MAV) platforms, respectively. Flights have been demonstrated with a 50W, 200Wh/kg battery for a 500g MAV.

Electric Vehicles

INTRODUCTION

We believe that electric buses represent a particularly important market for electric vehicles in the United States. An all-electric, full-size bus powered by the Electric Fuel system can provide to transit authorities a full day's operating range for both heavy duty city and suburban routes in all weather conditions. We conduct our electric vehicle activities through our subsidiary Electric Fuel Ltd.

THE ELECTRIC FUEL ZINC-AIR ENERGY SYSTEM FOR ELECTRIC VEHICLES

The Electric Fuel Zinc-Air Energy System consists of:

- an in-vehicle, Zinc-Air fuel cell unit consisting of a series of Zinc-Air cells and refuelable zinc-fuel anode cassettes using commercially-available zinc;
- a battery exchange unit for fast vehicle turnaround that is equivalent to the time needed to refuel a diesel bus;
- an automated battery refueling system for mechanically replacing depleted zinc-fuel cassettes with charged cassettes; and
- a regeneration system for electrochemical recycling and mechanical repacking of the discharged fuel cassettes.

With its proprietary high-power air cathode and zinc anode technologies, our Zinc-Air fuel cell delivers a unique combination of high-energy density and high-power density, which together power electric vehicles with speed, acceleration, driving range and driver convenience similar to that of conventionally powered vehicles.

THE DEPARTMENT OF TRANSPORTATION-FEDERAL TRANSIT ADMINISTRATION ZINC-AIR ALL ELECTRIC TRANSIT BUS PROGRAM

In the United States, our Zinc-Air technology is the focus of a Zinc-Air All Electric Bus demonstration program the costs and expenditures of which are 50% offset by subcontracting fees paid by the U.S. Department of Transportation's Federal Transit Administration (FTA). The test program is designed to prove that an all-electric bus can meet these and all other Los Angeles and New York Municipal Transit Authority mass transit requirements including requirements relating to performance, speed, acceleration and hill climbing.

Phase IV of the program, which we began in October 2003, is a $1.5 million cost-shared program (half of which is funded by the FTA and the remainder by the program partners, including us) that will explore steps necessary for commercializing the all-electric zinc-air/ultracapacitor hybrid bus. It will focus on continued optimization of the propulsion system developed in previous phases, on additional vehicle and system testing, including testing alternative advanced auxiliary battery technologies, and on evaluating alternative zinc anodes, which are more commercially available in North America.

Lifejacket Lights

In 1996, we began to produce and market lifejacket lights built with our patented magnesium-cuprous chloride batteries, which are activated by immersion in water (water-activated batteries), for the aviation and marine safety and emergency markets. Additionally, in 2004 we added two new models to our line of lifejacket light, based on lithium batteries. At present we have a product line consisting of seven lifejacket light models, five for use with marine life jackets and two for use with aviation life vests, all of which 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. We manufacture, assemble and package all our lifejacket lights through EFL in our factory in Beit Shemesh, Israel.

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, 2004 and 2003, our backlog for the following years was approximately $25.0 million and $17.2 million, respectively, divided among our divisions as follows (backlog attributable to subsidiaries acquired after December 31, 2003 is given as it stood at such date in the books of the seller, prior to the acquisition):

Division	2004	2003
Simulation and Security Division	$ 12,691,000	$ 6,600,000
Battery and Power Systems Division	8,325,000	9,630,000
Armor Division	4,002,000	931,000
TOTAL:	$ 25,018,000	$17,161,000

Major Customers

During 2004, including all of our divisions, Bechtel Corporation accounted for approximately 24% of our revenues and various branches of the United States military accounted for approximately 13% of our revenues.

Price Range of Common Stock

Since February 1994, our common stock has been traded on the Nasdaq National Market. Our Nasdaq ticker symbol is currently "ARTX"; prior to February 2003, our Nasdaq ticker symbol was "EFCX." The following table sets forth, for the periods indicated, the range of high and low closing prices of our common stock on the Nasdaq National Market System:

Year Ended December 31, 2004	High	Low
Fourth Quarter	$ 2.16	$ 1.50
Third Quarter	$ 2.14	$ 1.18
Second Quarter	$ 4.34	$ 1.90
First Quarter	$ 2.53	$ 1.65
Year Ended December 31, 2003		
Fourth Quarter	$ 2.86	$ 1.28
Third Quarter	$ 1.62	$ 0.81
Second Quarter	$ 1.19	$ 0.49
First Quarter	$ 0.66	$ 0.43

As of February 28, 2005 we had approximately 322 holders of record of our common stock.

Dividends

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

Five-Year Summary of Selected Financial Data

The selected financial information set forth below with respect to the consolidated statement of operations for each of the five fiscal years in the period ended December 31, 2004, and with respect to the balance sheets at the end of each such fiscal year has been derived from our consolidated financial statements.

The results of operations, including revenue, operating expenses, and financial income, of the consumer battery segment for the years ended December 31, 2003, 2002, 2001 and 2000 have been reclassified in the accompanying statements of operations as discontinued operations. Our accompanying consolidated balance sheets at December 31, 2003, 2002, 2001 and 2000 give effect to the assets of the consumer battery business as discontinued operations within current assets and liabilities. Thus, the financial information presented herein includes only continuing operations.

As discussed in Note 1.b. to the Consolidated Financial Statements, the Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated for the matters set forth therein.

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.

	Year Ended December 31,				
	2000	2001	2002	2003*	2004
	(dollars in thousands, except per share data)				
Statement of Operations Data:					
Revenues	$ 1,490	$ 2,094	$ 6,407	$ 17,326	$ 49,954
Research and development expenses and costs of revenues	1,985	2,448	5,108	12,141	35,742
Selling, general and administrative expenses and their impairment and amortization of intangible assets	3,434	3,934	5,982	10,255	18,394
Operating loss	(3,929)	(4,288)	(4,683)	(5,070)	(4,182)
Financial income, net	544	263	100	(4,039)	4,229
Loss before minority interest in loss (earnings) of subsidiary and tax expenses	(3,385)	(4,026)	(4,583)	(9,109)	(8,411)
Taxes on income	–	–	–	(396)	(586)
Minority interest in loss (earnings) of subsidiary	–	–	(355)	157	(45)
Loss from continuing operations	(3,385)	(4,026)	(4,938)	(9,348)	(9,042)
Income (loss) from discontinued operations	(8,596)	(13,261)	(13,566)	110	–
Net loss for the period	(11,981)	(17,287)	(18,504)	(9,238)	(9,042)
Deemed dividend to certain stockholders of common stock	–	(1,197)	–	(350)	(3,329)
Net loss attributable to stockholders of common stock	$ (11,981)	$ (18,483)	$ (18,504)	$ (9,588)	$ (12,371)
Basic and diluted net loss per share from continuing operations	$ (0.18)	$ (0.21)	$ (0.15)	$ (0.24)	$ (0.13)
Loss per share for combined operations	$ (0.62)	$ (0.76)	$ (0.57)	$ (0.25)	$ (0.18)
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands)	19,243	24,200	32,382	38,890	69,933

	As At December 31,				
	2000	2001	2002	2003*	2004
Balance Sheet Data:					
Cash, cash equivalents, investments in marketable debt securities and restricted collateral deposits	$ 11,596	$ 12,672	$ 2,091	$ 14,391	$ 13,832
Receivables and other assets**	13,771	11,515	7,895	8,898	25,746
Property and equipment, net of depreciation	2,289	2,221	2,555	2,293	4,601
Goodwill and other intangible assets, net	–	–	7,522	7,440	54,113
Total assets	$ 27,656	$ 26,408	$ 20,063	$ 33,022	$ 98,292
Current liabilities**	$ 4,787	$ 3,874	$ 7,272	$ 6,710	$ 26,381
Long-term liabilities***	2,791	3,126	3,753	4,686	6,438
Stockholders' equity	20,078	19,408	9,038	21,626	65,473
Total liabilities and stockholders equity**	$ 27,656	$ 26,408	$ 20,063	$ 33,022	$ 98,292

*Restated (see Note 1.b. of Notes to Consolidated Financial Statements contained elsewhere in this annual report).
**Includes assets and liabilities, as applicable, from discontinued operations.
***Includes minority interest.

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

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," "anticipated," "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. Please see "Risk Factors," below, and in our other filings with the Securities and Exchange Commission.

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements contained elsewhere in this annual report, and the notes thereto. 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 products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate in three business units:

- we develop, manufacture and market advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement, security and other personnel (our ***Simulation and Security Division***);
- we manufacture aviation armor and we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our ***Armor Division***); and
- we manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air battery technology for electric vehicles (our ***Battery and Power Systems Division***).

During 2004, we acquired three new businesses: FAAC Corporation, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (which we have placed in our Simulation and Security Division); Epsilor Electronic Industries, Ltd., located in Dimona, Israel, which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia (which we have placed in our Battery and Power Systems Division); and Armour of America, Incorporated, located in Los Angeles, California, which manufacturers aviation armor both for helicopters and for fixed wing aircraft, marine armor, personnel armor, armoring kits for military vehicles, fragmentation blankets and a unique ballistic/flotation vest (ArmourFloat) that is U.S. Coast Guard-certified, which we have placed in our Armor Division. Prior to the acquisition of FAAC and Epsilor, we were organized into two divisions: Defense and Security Products (consisting of IES, MDT and MDT Armor), and Electric Fuel Batteries (consisting of EFL and EFB). Our financial results for 2003 do not include the activities of FAAC, Epsilor or AoA and therefore are not directly comparable to our financial results for 2004.

Restatement of Previously-Issued Financial Statements

During our management's review of our interim financial statements for the period ended September 30, 2004, we, after discussion with and based on a new and revised review of accounting treatment by our independent auditors, conducted a comprehensive review of the repricing of warrants and grant of new warrants to certain of our investors and others during the years 2004 and 2003. As a result of that review,

we, upon recommendation of our management and with the approval of the Audit Committee of our Board of Directors after discussion with our independent auditors, reconsidered the accounting related to these transactions and reclassified certain expenses as a deemed dividend, a non-cash item, instead of as general and administrative expenses due to the recognition of these transactions as capital transactions that should not be expensed. These restatements did not affect our balance sheet, shareholders' equity or cash flow statements. In addition and as a result of the remeasurement described above, we have reviewed assumptions used in the calculation of fair value of all warrants granted during the year 2003. As a result of this comprehensive review, we have decreased general and administrative expenses in the amount of $150,000, related to errors found in the valuation of warrants granted in the litigation settlement described in Note 14.f.6. of the Notes to Consolidated Financial Statements for the year ended December 31, 2004.

In addition, during our management's review of our interim financial statements for the period ended September 30, 2004, we also reviewed our calculation of amortization of debt discount attributable to the beneficial conversion feature associated with our convertible debentures. As a result of this review, we found errors which increased our financial expenses in the amount of $568,000 for the year ended December 31, 2003. The errors were related to the amortization of debt discount attributable to the warrants and the related convertible debentures, whereby we understated the amount of amortization for the year ended December 31, 2003 attributable to certain of the convertible debentures.

Similar errors were also noted in our interim financial statements in the three-month period ended June 30, 2003, the nine-month period ended September 30, 2003, and the three- and six-month periods ended March 31 and June 30, 2004.

The impacts of these restatements with respect to the year ended December 31, 2003 are summarized below:

Statement of Operations Data:

	For the Year Ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
General and administrative expenses	$ 6,196,779	$ (338,903)	$ 5,857,876
Operating loss	5,408,932	(338,903)	5,070,029
Financial expenses, net	3,470,459	568,250	4,038,709
Loss from continuing operations	9,118,684	229,347	9,348,031
Net loss	9,008,274	229,347	9,237,621
Deemed dividend to certain stockholders of common stock	–	350,000	350,000
Net loss attributable to common stockholders	$ 9,008,274	$ 579,347	$ 9,587,621
Basic and diluted net loss per share from continuing operations	$ 0.23	$ 0.01	$ 0.24
Basic and diluted net loss per share	$ 0.23	$ 0.02	$ 0.25

Balance Sheet Data:

	For the Year Ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
Other accounts payable and accrued expenses	$4,180,411	$ (150,000)	$ 4,030,411
Total current liabilities	6,859,752	(150,000)	6,709,752
Convertible debenture	881,944	568,250	1,450,194
Total long-term liabilities	4,066,579	568,250	4,634,829
Additional paid-in capital	135,891,316	(188,903)	135,702,413
Accumulated deficit	(109,681,893)	(229,347)	(109,911,240
Total stockholders' equity	22,044,127	(418,250)	21,625,877

Cash Flow Data:

	For the Year Ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
Net loss	$ 9,008,274	$ 229,347	$ 9,237,621
Stock based compensation related to repricing of warrants granted to investors and the grant of new warrants	388,403	(188,903)	199,500
Increase in other accounts payable and accrued expenses	1,827,668	(150,000)	1,677,668
Amortization of compensation related to beneficial conversion feature and warrants issued to holders of convertible debentures	3,359,987	568,250	3,928,237

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, inventory, contingencies and warranty reserves, 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

Significant management judgments and estimates must be made and used in connection with the recognition of revenue in any accounting period. Material differences in the amount of revenue in any given period may result if these judgments or estimates prove to be incorrect or if management's estimates change on the basis of development of the business or market conditions. Management judgments and estimates have been applied consistently and have been reliable historically.

A portion of our revenue is derived from license agreements that entail the customization of FAAC's simulators to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with Statement of Position 81-1 "Accounting for Performance of Construction – Type and Certain Production – Type Contracts" based on the percentage of completion method over the period from signing of the license through to customer acceptance, as such simulators require significant modification or customization that takes time to complete. The percentage of completion is measured by monitoring progress using records of actual time incurred to date in the project compared with the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

We believe that the use of the percentage of completion method is appropriate as we have the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases we expect to perform our contractual obligations and our licensees are expected to satisfy their obligations under the contract. The complexity of the estimation process and the issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our consolidated financial statements. A number of internal and external factors can affect our estimates, including labor rates, utilization and specification and testing requirement changes.

We account for our other revenues from IES simulators in accordance with the provisions of SOP 97-2, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants and as amended by SOP 98-4 and SOP 98-9 and related interpretations. We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

We assess whether collection is probable at the time of the transaction based on a number of factors, including the customer's past transaction history and credit worthiness. If we determine that the collection of the fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon the receipt of cash.

Allowance for Doubtful Accounts

We make judgments as to our ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding receivables. In determining the provision, we analyze our historical collection experience and current economic trends. We reassess these allowances each accounting period. Historically, our actual losses and credits have been consistent with these provisions. If actual payment experience with our customers is different than our estimates, adjustments to these allowances may be necessary resulting in additional charges to our statement of operations.

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 and expense to avoid double taxation. Although we believe that our estimates are reasonable, the final tax out-

come of these matters may be different than that which is reflected in our historical income tax provisions and accruals. Such differences could have a material effect on our income tax provision and net income (loss) in the period in which such determination is made.

We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("Statement 109"), 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. The Company and its subsidiaries provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. The company does not provide for US Federal Income taxes on the undistributed earnings of its foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

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 estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2004, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

Under Financial Accounting Standards Board Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS 142.

In June 2004, we completed our annual impairment test and assessed the carrying value of goodwill as required by SFAS 142. The goodwill impairment test compared the carrying value of the Company's reporting units with the fair value at that date. Because the market capitalization exceeded the carrying value significantly, no impairment arose.

We determine fair value using discounted cash flow analysis. This type of analysis requires us to make assumptions and estimates regarding industry economic factors and the profitability of future business strategies. It is our policy to conduct impairment testing based on our current business strategy in light of present industry and economic conditions, as well as future expectations. In assessing the recoverability of our goodwill, we may be required to make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. This process is subjective and requires judgment at many points throughout the analysis. If our estimates or their related assumptions change in subsequent periods or if actual cash flows are below our estimates, we may be required to record impairment charges for these assets not previously recorded.

Other Intangible Assets

Other intangible assets are amortized to the Statement of Operations over the period during which benefits are expected to accrue, currently estimated at two to ten years.

We recorded a $320,000 impairment charge in 2004 in respect of certain technology acquired from Bristlecone in 2003.

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.

Contingencies

We are from time to time 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.

Warranty Reserves

Upon shipment of products to our customers, we provide for the estimated cost to repair or replace products that may be returned under warranty. Our warranty period is typically twelve months from the date of shipment to the end user customer. For existing products, the reserve is estimated based on actual historical experience. For new products, the warranty reserve is based on historical experience of similar products until such time as sufficient historical data has been collected on the new product. Factors that may impact our warranty costs in the future include our reliance on our contract manufacturer to provide quality products and the fact that our products are complex and may contain undetected defects, errors or failures in either the hardware or the software.

Functional Currency

We consider the United States dollar to be the currency of the primary economic environment in which we and our Israeli subsidiary EFL operate and, therefore, both we and EFL have adopted and are using the United States dollar as our functional currency. Transactions and balances originally denominated in U.S. dollars are presented at the original amounts. Gains and losses arising from non-dollar transactions and balances are included in net income.

The majority of financial transactions of our Israeli subsidiaries MDT and Epsilor is in New Israel Shekels ("NIS") and a substantial portion of MDT's and Epsilor's costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT and Epsilor. Accordingly, the financial statements of MDT and Epsilor have been translated into U.S. dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive loss in shareholders' equity.

Executive Summary

The following executive summary includes discussion of our new subsidiaries, FAAC Incorporated, Epsilor Electronic Industries, Ltd. and Armour of America Incorporated, that we purchased in 2004.

Divisions and Subsidiaries

We operate primarily as a holding company, through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned, unless otherwise noted) are as follows:

- Our ***Simulation and Security Division***, consisting of:
    - FAAC Incorporated, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry ("FAAC"); and
    - IES Interactive Training, Inc., located in Littleton, Colorado, which provides specialized "use of force" training for police, security personnel and the military ("IES").
- Our ***Armor Division***, consisting of:

- Armour of America, located in Los Angeles, California, which manufacturers ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles and architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique vest that is certified by the U.S. Coast Guard ("AoA");
- MDT Protective Industries, Ltd., located in Lod, Israel, which specializes in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs, and is a leading supplier to the Israeli military, Israeli special forces and special services ("MDT") (75.5% owned); and
- MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT's United States activities ("MDT Armor") (88% owned).

➢ Our ***Battery and Power Systems Division***, consisting of:

- Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area), which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia ("Epsilor");
- Electric Fuel Battery Corporation, located in Auburn, Alabama, which manufactures and sells Zinc-Air fuel sells, batteries and chargers for the military, focusing on applications that demand high energy and light weight ("EFB"); and
- Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel, which produces water-activated lifejacket lights for commercial aviation and marine applications, and which conducts our Electric Vehicle effort, focusing on obtaining and implementing demonstration projects in the U.S. and Europe, and on building broad industry partnerships that can lead to eventual commercialization of our Zinc-Air energy system for electric vehicles ("EFL").

Overview of Results of Operations

We incurred significant operating losses for the years ended December 31, 2004, 2003 and 2002. While we expect to continue to derive revenues from the sale of products that we manufacture and the services that we provide, there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis.

During 2003 and 2004, we substantially increased our revenues and reduced our net loss, from $18.5 million in 2002 to $9.2 million in 2003 to $9.0 million in 2004. This was achieved through a combination of cost-cutting measures and increased revenues, particularly from the sale of Zinc-Air batteries to the military and from sales of products manufactured by the subsidiaries we acquired in 2002 and 2004.

We succeeded during 2004 in moving Arotech to a positive EBITDA situation, for the first time in our history. We are focused on continuing this success in 2005 and beyond, and ultimately on achieving profitability. In this connection, we note that most of our business lines historically have had weaker first halves than second halves, and weaker first quarters than second quarters. We expect this to be the case for 2005 as well.

A portion of our operating loss during 2004 and 2003 arose as a result of non-cash charges. These charges were primarily related to our acquisitions, financings and issuances of restricted shares and options to employees. Because we anticipate continuing certain of these activities during 2005, we expect to continue to incur such non-cash charges in the future.

Acquisitions

In acquisition of subsidiaries, part of the purchase price is allocated to intangible assets and goodwill, Amortization of intangible assets related to acquisition of subsidiaries is recorded based on the estimated expected life of the assets. Accordingly, for a period of time following an acquisition, we incur a non-cash charge related to amortization of intangible assets in the amount of a fraction (based on the useful life of the intangible assets) of the amount recorded as intangible assets. Such amortization charges will continue during 2005. We are required to review intangible assets for impairment whenever events or changes in circum-

stances indicate that carrying amount of the assets may not be recoverable. If we determine, through the impairment review process, that intangible asset has been impaired, we must record the impairment charge in our statement of operations.

In the case of goodwill, the assets recorded as goodwill are not amortized; instead, we are required to perform an annual impairment review. If we determine, through the impairment review process, that goodwill has been impaired, we must record the impairment charge in our statement of operations.

As a result of the application of the above accounting rule, we incurred non-cash charges for amortization of intangible assets and impairment in the amount of $2.8 million during 2004. See "Critical Accounting Policies – Other Intangible Assets," above.

FINANCINGS

The non-cash charges that relate to our financings occurred in connection with our issuance of convertible debentures with warrants, and in connection with our repricing of certain warrants and grants of new warrants. When we issue convertible debentures, we record a discount for a beneficial conversion feature that is amortized ratably over the life of the debenture. When a debenture is converted, however, the entire remaining unamortized beneficial conversion feature expense is immediately recognized in the quarter in which the debenture is converted. Similarly, when we issue warrants in connection with convertible debentures, we record debt discount for financial expenses that is amortized ratably over the term of the convertible debentures; when the convertible debentures are converted, the entire remaining unamortized debt discount is immediately recognized in the quarter in which the convertible debentures are converted. As and to the extent that our remaining convertible debentures are converted, we would incur similar non-cash charges going forward.

As a result of the application of the above accounting rule, we incurred non-cash charges related to amortization of debt discount attributable to beneficial conversion feature in the amount of $4.1 million during 2004.

As a result of the application of the above accounting rule, we recorded a deemed dividend related to warrants repricing and grant of new warrants in the amount of $3.3 million during 2004.

RESTRICTED SHARE AND OPTION ISSUANCES

During 2004, we issued restricted shares to certain of our employees. These shares were issued as stock bonuses, and are restricted for a period of two years from the date of issuance. Relevant accounting rules provide that the aggregate amount of the difference between the purchase price of the restricted shares (in this case, generally zero) and the market price of the shares on the date of grant is taken as a general and administrative expense, amortized over the life of the period of the restriction.

Additionally, during 2003 and 2004 we issued options to employees that were subject to shareholder approval of a new stock option plan. While the options were issued at the market price of our stock on the respective dates of issuance, they were not considered by applicable accounting rules to have been finally issued until the date shareholder approval for the new stock option plan was obtained. In the interim, the market price of our stock had risen, and thus the options were deemed to have been issued at a below-market price. We were therefore required to take as a general and administrative expense the aggregate difference between the option exercise prices of the options and the market price of the shares on the date shareholder approval was obtained, amortized over the vesting periods of the options.

As a result of the application of the above accounting rules, we incurred non-cash charges related to stock-based compensation in the amount of $884,000 during 2004.

Overview of Financial Condition and Operating Performance

We shut down our money-losing consumer battery operations and began acquiring new businesses in the defense and security field in 2002. Thereafter, we concentrated on eliminating our operating deficit and moving Arotech to cash-flow positive operations, a goal we achieved for the first time in our history in the second half of 2004. In order to do this, we focused on acquiring businesses with strong revenues and profitable operations.

In our Simulation and Security Division, revenues grew from approximately $8.0 million in 2003 to $21.5 million in 2004 (on a pro forma basis, assuming we had owned all components of our Simulation and Security Division since January 1, 2003, revenues would have grown from approximately $17.9 million in 2003 to $21.5 million in 2004). We attribute this to a number of substantial orders, such as orders from the U.S. Army and the Chicago

Transit Authority. As of December 31, 2004, our backlog for our Simulation and Security Division totaled $12.7 million.

Our Armor Division had record revenues during 2004, with revenues growing from approximately $3.4 million in 2003 to $18.0 million in 2004 (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2003, revenues would have grown from approximately $10.9 million in 2003 to $29.2 million in 2004). Much of this growth was attributable to armoring orders connected with the war in Iraq. As of December 31, 2004, our backlog for our Armor Division totaled $4.0 million.

In our Battery and Power Systems Division, revenues grew from approximately $5.9 million in 2003 to $10.5 million in 2004 (on a pro forma basis, assuming we had owned all components of our Battery and Power Systems Division since January 1, 2003, revenues would have fallen from approximately $10.8 million in 2003 to $10.5 million in 2004). As of December 31, 2004, our backlog for our Battery and Power Systems Division totaled $8.3 million.

Results of Operations

Preliminary Note

SUMMARY

Results of operations for the year ended December 31, 2004 include the results of FAAC, Epsilor and AoA for the periods following our acquisition of each such company during 2004. However, the results of these subsidiaries were not included in our operating results for the year ended December 31, 2003. Accordingly, the following year-to-year comparisons should not necessarily be relied upon as indications of future performance.

Following is a table summarizing our results of operations for the years ended December 31, 2004 and 2003, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2004	2003*
Revenues:		
Simulation and Security Division	$ 21,464,406	$ 8,022,026
Armor Division	17,988,687	3,435,716
Battery and Power Systems Division	10,500,753	5,868,899
	$49,953,846	$17,326,641
Cost of revenues:		
Simulation and Security Division	$11,739,690	$ 3,944,701
Armor Division	15,449,084	2,621,550
Battery and Power Systems Division	6,822,320	4,521,589
	$34,011,094	$11,087,840
Research and development expenses:		
Simulation and Security Division	$ 395,636	$ 132,615
Armor Division	17,065	84,186
Battery and Power Systems Division	1,318,678	836,607
	$ 1,731,379	$ 1,053,408
Sales and marketing expenses:		
Simulation and Security Division	$ 3,185,001	$ 2,237,386
Armor Division	565,981	180,631
Battery and Power Systems Division	1,171,235	926,872
All other	–	187,747
	$ 4,922,217	$ 3,532,636
General and administrative expenses:		
Simulation and Security Division	$ 2,852,969	$ 1,001,404
Armor Division	1,323,982	518,053
Battery and Power Systems Division	965,058	188,655
All other	5,514,857	4,149,764
	$10,656,866	$ 5,857,876
Financial expense (income):		
Simulation and Security Division	$ 27,842	$ (119,750)
Armor Division	13,503	(19,918)
Battery and Power Systems Division	54,511	7,936
All other	4,133,109	4,170,441
	$ 4,228,965	$ 4,038,709
Tax expenses:		
Simulation and Security Division	$ 77,811	$ 30,130
Armor Division	134,949	363,173
Battery and Power Systems Division	320,878	–
All other	52,471	2,890
	$ 586,109	$ 396,193
Amortization of intangible asset and impairment losses:		
Simulation and Security Division	$ 1,643,682	$ 720,410
Armor Division	661,914	144,500
Battery and Power Systems Division	509,239	–
	$ 2,814,835	$ 864,910
Minority interest in loss (profit) of subsidiaries:		
Simulation and Security Division	$ –	$ –
Armor Division	(44,694)	156,900
Battery and Power Systems Division	–	–
	$ (44,694)	$ 156,900
Loss from continuing operations:		
Simulation and Security Division	$ 1,541,775	$ 75,130
Armor Division	(222,485)	(299,559)
Battery and Power Systems Division	(661,166)	(612,760)
All other	(9,700,437)	(8,510,842)
	$ (9,042,313)	$ (9,348,031)
Income from discontinued operations:		
Simulation and Security Division	$ –	$ –
Armor Division	–	–
Battery and Power Systems Division	–	110,410
	$ –	$ 110,410
Net loss:		
Simulation and Security Division	$ 1,541,775	$ 75,130
Armor Division	(222,485)	(299,559)
Battery and Power Systems Division	(661,166)	(502,350)
All other	(9,700,437)	(8,510,842)
	$ (9,042,313)	$ (9,237,621)

*Restated (see Note 1.b. of Notes to Consolidated Financial Statements).

ADJUSTED EBITDA

In this Item, we use the term "Adjusted EBITDA." Each reference to Adjusted EBITDA herein is qualified by reference to, and should be read in conjunction with, this section and the reconciliation contained herein.

Adjusted EBITDA, as used herein, is defined as earnings before income taxes, interest expenses, depreciation and amortization, as adjusted to eliminate certain non-cash charges. Adjusted EBITDA is provided solely as a supplemental disclosure because we believe that it enhances overall understanding of our current financial performance and our progress toward cash-flow break even and toward GAAP profitability.

Adjusted EBITDA is a non-GAAP financial measure as defined in SEC Regulation G. Adjusted EBITDA is presented because it is a widely accepted financial indicator used by investors and analysts to analyze and compare companies on the basis of cash-flow break even and debt service capability. We use Adjusted EBITDA to set targets and monitor and assess financial performance. Adjusted EBITDA should not be considered in isolation. It is not intended to represent cash flows for the periods presented, nor has it been presented as an alternative to net loss as an indicator of operating performance or to cash flow as a measure of liquidity.

The most nearly comparable GAAP measure to Adjusted EBITDA is net income or loss. Following is a reconciliation between our net loss and our Adjusted EBITDA for the years ended December 31, 2004, 2003 and 2002:

ADJUSTED EBITDA

	2004	2003*	2002
Net loss from continuing operations before deemed dividend to certain shareholders (GAAP measure)	$(9,042,313)	$(9,348,031)	$(4,938,152)
Add back:			
Interest expense (income), net (after deduction of minority interest)	4,226,312	4,039,950	(99,150)
Taxes (after deduction of minority interest)	555,507	240,039	–
Depreciation of fixed assets	1,199,465	730,159	473,739
Amortization of inventory adjustment to market values with the acquisition of one of our subsidiaries	920,544	–	–
Amortization of intangible assets, capitalized software costs and technology impairment	2,888,226	879,312	649,543
EBITDA (non-GAAP measure)	$ 747,741	$(3,458,571)	$(3,914,020)
Add back certain non-cash charges:			
Write-down of promissory notes	–	–	394,452
Expenses attributed on issuance of shares to consultants and as a donation	89,078	333,627	–
Expenses attributed on issuance of warrants and options to employees, directors and consultants	662,392	276,045	19,000
Expenses attributed on issuance of shares to employees	212,424	–	–
Markdown of loans to shareholders	45,253	–	–
Non-cash portion of settlement agreement	–	688,642	–
ADJUSTED EBITDA (non-GAAP measure)	$ 1,756,888	$(2,160,257)	$(3,500,568)
Net loss from continuing operations before deemed dividend to certain shareholders (GAAP measure)	$(9,042,313)	$(9,348,031)	$(4,938,152)

*Restated (see Note 1.b. of Notes to Consolidated Financial Statements).

The Adjusted EBITDA information presented herein may not be comparable to similarly titled measures employed by other companies.

Fiscal Year 2004 compared to Fiscal Year 2003

Revenues. During 2004, we recognized revenues as follows:

- From the sale of interactive training systems and from the provision of warranty services in connection with such systems (FAAC and IES);
- From payments under armor contracts and for service and repair of armored vehicles (AoA and MDT);
- From the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (EFB and Epsilor);
- From the sale of lifejacket lights (EFL); and
- From subcontracting fees received in connection with Phase III of the United States Department of Transportation (DOT) electric bus program, which began in October 2003 and was completed in March 2004. Phase IV of the DOT program, which began in October 2004, did not result in any revenues during 2004 (EFL).

Revenues from continuing operations for the year ended December 31, 2004 totaled $50.0 million, compared to $17.3 million for 2003, an increase of $32.6 million, or 188%. This increase was primarily attributable to the following factors:

- Increased revenues from vehicle armoring; and
- Revenues generated by FAAC, Epsilor and AoA in 2004 that were not present in 2003.

These increases were offset to some extent by decreased revenues from sales of interactive use-of-force training systems and decreased revenues from sales of our Zinc-Air military batteries.

In 2004, revenues were $21.5 million for the Simulation and Security Division (compared to $8.0 million in 2003, an increase of $13.4 million, or 168%, due primarily to the added revenues from sales of driver training systems since we acquired FAAC (approximately $16.5 million), offset to some extent by decreased revenues from use-of-force training systems); $18.0 million for the Armor Division (compared to $3.4 million in 2003, an increase of $14.6 million, or 424%, due primarily to increased revenues from vehicle armoring and to the added revenues from aircraft armoring since we acquired AoA);

and $10.5 million for the Battery and Power Systems Division (compared to $5.9 million in 2003, an increase of $4.6 million, or 79%, due primarily to the added revenues from sales of lithium batteries and chargers since we acquired Epsilor (approximately $5.3 million), offset to some extent by decreased revenues from our Zinc-Air military batteries).

Cost of revenues and gross profit. Cost of revenues totaled $34.0 million during 2004, compared to $11.1 million in 2003, an increase of $22.9 million, or 207%, due to increased cost of goods sold, particularly in the Armor Division (partly as a result of our beginning to sell pre-armored vehicles in 2004, which requires us to purchase vehicles for pre-armoring) and in the Simulation and Security Division, as well as the inclusion of the cost of goods of FAAC, Epsilor and AoA in our results for 2004 but not 2003.

Direct expenses for our three divisions during 2004 were $17.9 million for the Simulation and Security Division (compared to $7.3 million in 2003, an increase of $10.6 million, or 145%, due primarily to the addition of expenses associated with sales of driver training systems through FAAC (approximately $12.0 million), offset to some extent by decreased expenses associated with the sales of use-of-force training systems); $16.4 million for the Armor Division (compared to $3.6 million in 2003, an increase of $12.9 million, or 359%, due primarily to increased expenses associated with sales of vehicle armoring (a $12.1 million increase in 2004, including the expenses of purchasing vehicles for pre-armoring in 2004, which was not present in 2003), and to the addition beginning in August 2004 of expenses associated with sales of aircraft armoring through our new subsidiary AoA); and $10.0 million for the Battery and Power Systems Division (compared to $5.9 million in 2003, an increase of $4.0 million, or 68%, due primarily to the addition of expenses associated with sales of lithium batteries and chargers through our new Epsilor subsidiary ($4.2 million), offset to some extent by decreased expenses associated with the sales of Zinc-Air military batteries).

Gross profit was $15.9 million during 2004, compared to $6.2 million during 2003, an increase of $9.7 million, or 155%. This increase was the direct result of all factors presented above, most notably the inclusion of FAAC, Epsilor and AoA in our results for 2004 ($10.2 million), as well as the increased revenues from vehicle armoring ($1.6 million), offset to some extent by a decrease of $2.0 million in gross profit from IES.

Research and development expenses. Research and development expenses for 2004 were $1.7 million, compared to $1.1 million in 2003, an increase of $678,000, or 64%. This increase was primarily the result of the inclusion of the research and development expenses of FAAC, Epsilor and AoA in our results in 2004 ($533,000) and increased research and development expenses of EFL and EFB.

Sales and marketing expenses. Sales and marketing expenses for 2004 were $4.9 million, compared to $3.5 million in 2003, an increase of $1.4 million, or 39%. This increase was primarily attributable to the inclusion of the sales and marketing expenses of FAAC, Epsilor and AoA in our results for 2004 ($2.0 million), offset to some extent by a decrease of $600,000 in expenses related to our military batteries and a decrease in sales and marketing expenses related to interactive use-of-force training.

General and administrative expenses. General and administrative expenses for 2004 were $10.7 million, compared to $5.9 million in 2003, an increase of $4.8 million, or 82%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of FAAC, Epsilor and AoA in our results for 2004 ($2.4 million);
- Expenses in 2004 in connection with grant of options and shares to employees that were not present in 2003 ($830,000);
- Costs associated with our compliance with Section 404 of the Sarbanes-Oxley Act of 2002 that were not present in 2003 ($150,000); and
- Increases in other general and administrative expenses, such as employee salaries and bonuses, travel expenses, audit fees, director fees, legal fees, and expenses related to due diligence performed in connection to certain potential acquisitions, that were not present in 2003.

We are not anticipating a reduction in our general and administrative expenses in the coming year, and we expect that our travel expenses, audit fees, legal fees, and due diligence expenses will continue or increase to the extent that we continue to pursue acquisitions in the future.

These increases were offset to some extent by:

- Expenses in 2003 in connection with a litigation settlement agreement that were not present in 2004 ($700,000); and
- Amortization of legal and consulting expenses in 2003 in connection with our convertible debentures that were lower (by $260,000) than in 2004.

Adjusted EBITDA. Due to the factors cited above, we had Adjusted EBITDA of $1.8 million in 2004, compared to Adjusted EBITDA of $(2.2) million in 2003. For an explanation of Adjusted EBITDA, a non-GAAP measure, and a reconciliation with the most nearly comparable GAAP measure, see "Results of Operations – Preliminary Note – Adjusted EBITDA," above.

Financial expenses, net. Financial expense, net of interest income and exchange differentials, totaled approximately $4.2 million in 2004 compared to $4.0 million in 2003, an increase of $190,000, or 5%. This difference was due primarily to amortization of debt discount related to the issuance of convertible debentures and their conversion, as well as interest expenses related to those debentures.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2004 and, accordingly, we were not required to make any provision for income taxes. With respect to some of our subsidiaries that operated at a net profit during 2004, we were able to offset federal taxes against our net operating loss carry forwards. We recorded a total of $586,000 in tax expenses in 2004, with respect to certain of our subsidiaries that operated at a net profit during 2004 and we are not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes. In 2003, tax expenses were recorded with respect to MDT's taxable income. Out of the $586,000 tax expense that we recorded in 2004, $84,000 was related to prior years and $(37,000) represented income from deferred taxes, net.

Amortization of intangible assets. Amortization of intangible assets totaled $2.8 million in 2004, compared to $865,000 in 2003, an increase of $1.9 million, or 225%, resulting from the inclusion of the amortization of the intangible assets of FAAC, Epsilor and AoA in our results in 2004 and impairment in the amount of $320,000 of technology previously purchased by IES from Bristlecone Technologies.

Net loss before deemed dividend of common stock to certain stockholders. Due to the factors cited above, we reported a net loss of $9.0 million in 2004, compared to a net loss of $9.2 million in 2003, a decrease of $195,000, or 2%.

Net loss after deemed dividend of common stock to certain stockholders was $12.4 million due to a deemed dividend of $3.3 million (see Notes 14.f.4. and 14.f.5. to the financial statements) compared to $9.6 million in 2003, an increase of 2.8 million, or 29%.

Fiscal Year 2003 compared to Fiscal Year 2002

Revenues. During 2003, we (through our subsidiaries) recognized revenues as follows:

- IES recognized revenues from the sale of interactive use-of-force training systems and from the provision of warranty services in connection with such systems;
- MDT recognized revenues from payments under vehicle armoring contracts and for service and repair of armored vehicles;
- EFB recognized revenues from the sale of batteries and adapters to the military, and under certain development contracts with the U.S. Army;
- Arocon recognized revenues under consulting agreements; and
- EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase III of the United States Department of Transportation (DOT) electric bus program, which began in October 2002 and was completed in March 2004. Phase IV of the DOT program, which began in October 2003, did not result in any revenues during 2003.

Revenues from continuing operations for the year ended December 31, 2003 totaled $17.3 million, compared to $6.4 million for 2002, an increase of $10.9 million, or 170%. This increase was primarily the result of increased sales attributable to IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002.

In 2003, revenues were $8.0 million for the Simulation and Security Division (compared to $2.0 million in 2002, an increase of $6.0 million, or 305%, due primarily to the inclusion of IES in our results for the full year of 2003 but only part of 2002), $5.9 million for the Battery and Power

Systems Division (compared to $1.7 million in the comparable period in 2002, an increase of $4.2 million, or 249%, due primarily to increased sales to the U.S. Army on the part of EFB), and $3.4 million for the Armor Division (compared to $2.7 million in 2002, an increase of $691,000, or 25%, due primarily to the inclusion of MDT in our results for the full year of 2003 but only part of 2002).

Cost of revenues and gross profit. Cost of revenues totaled $11.1 million during 2003, compared to $4.4 million in 2002, an increase of $6.7 million, or 151%, due to increased cost of goods sold, particularly by IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002.

Direct expenses for our three divisions during 2003 were $7.3 million for the Simulation and Security Division (compared to $2.0 million in 2002, an increase of $5.3 million, or 259%, due primarily to increased sales attributable to the inclusion of IES in our results for the full year of 2003 but only part of 2002), $5.9 million for the Battery and Power Systems Division (compared to $3.1 million in the comparable period in 2002, an increase of $2.9 million, or 94%, due primarily to increased sales on the part of EFB to the U.S. Army), and $3.6 million for the Armor Division (compared to $2.3 million in 2002, an increase of $1.3 million, or 55%, due primarily to the inclusion of MDT in our results for the full year of 2003 but only part of 2002).

Gross profit was $6.2 million during 2003, compared to $2.0 million during 2002, an increase of $4.3 million, or 214%. This increase was the direct result of all factors presented above, most notably the increased sales of IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002. In 2003, IES contributed $4.1 million to our gross profit, EFB contributed $1.6 million, and MDT contributed $833,000.

Research and development expenses. Research and development expenses for 2003 were $1.1 million, compared to $686,000 in 2002, an increase of $367,000, or 54%. This increase was primarily because certain research and development personnel who had worked on the discontinued consumer battery operations during 2002 (the expenses of which are not reflected in the 2002 number above) were reassigned to military battery research and development in 2003.

Sales and marketing expenses. Sales and marketing expenses for 2003 were $3.5 million, compared to $1.3 million in 2002, an increase of $2.2 million, or 170%. This increase was primarily attributable to the following factors:

- The inclusion of the sales and marketing expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;
- An increase in IES's sales activity during 2003, which resulted in both increased sales and increased sales and marketing expenses during 2003; and
- We incurred expenses for consultants in the amount of $810,000 in connection with our CECOM battery program with the U.S. Army and $345,000 in connection with our security consulting business.

General and administrative expenses. General and administrative expenses for 2003 were $5.9 million, compared to $4.0 million in 2002, an increase of $1.8 million, or 46%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;
- Expenses in 2003 in connection with a litigation settlement agreement, in the amount of $714,000, that were not present in 2002;
- Expenses in 2003 in connection with warrant grants, in the amount of $199,500, that were not present in 2002;
- Legal and consulting expenses in 2003 in connection with our convertible debentures, in the amount of $484,000, that were not present in 2002; and
- Expenses in 2003 in connection with the start-up of our security consulting business in the United States and with the beginning of operations of MDT Armor, in the amount of $250,000, that were not present in 2002.

Adjusted EBITDA. Due to the factors cited above, we had Adjusted EBITDA of $(2.2) million in 2003, compared to Adjusted EBITDA of $(3.5) million in 2002. For an explanation of Adjusted EBITDA, a non-GAAP measure, and a reconciliation with the most nearly comparable GAAP measure, see "Results of Operations – Preliminary Note – Adjusted EBITDA," above.

Financial income (expense). Financial expense totaled approximately $4.0 million in 2003 compared to financial income of $100,000 in 2002,

an increase of $4.1 million. This increase was due primarily to amortization of compensation related to the issuance of convertible debentures issued in December 2002 and during 2003 in the amount of $3.9 million, and interest expenses related to those debentures in the amount of $376,000.

Tax expenses. We and our Israeli subsidiary EFL incurred net operating losses during 2003 and 2002 and, accordingly, we were not required to make any provision for income taxes. MDT and IES had taxable income, and accordingly we were required to make provision for income taxes in the amount of $396,000 in 2003. We were able to offset IES's federal taxes against our loss carryforwards. In 2002 we did not accrue any tax expenses due to our belief that we would be able to utilize our loss carryforwards against MDT's taxable income, estimation was revised in 2003. Of the amount accrued in 2003, approximately $352,000 was accrued on account of income in 2002.

Amortization of intangible assets and in-process research and development. Amortization of intangible assets totaled $865,000 in 2003, compared to $649,000 in 2002, an increase of $215,000, or 33%, resulting from amortization of these assets subsequent to our acquisition of IES and MDT in 2002. Of this $215,000 increase, $169,000 was attributable to IES and $46,000 was attributable to MDT.

Loss from continuing operations. Due to the factors cited above, we reported a net loss from continuing operations of $9.3 million in 2003, compared to a net loss of $4.9 million in 2002, an increase of $4.4 million, or 90%.

Profit (loss) from discontinued operations. In the third quarter of 2002, we decided to discontinue operations relating to the retail sales of our consumer battery products. Accordingly, all revenues and expenses related to this segment have been presented in our consolidated statements of operations for the years ended December 31, 2003 and 2002 in an item entitled "Loss from discontinued operations."

Income from discontinued operations in 2003 was $110,000, compared to a loss of $13.6 million in 2002, a decrease of $13.7 million. This decrease was the result of the elimination of the losses from these discontinued operations beginning with the fourth quarter of 2002. The income from discontinued operations was primarily from cancellation of past accruals made unnecessary by the closing of the discontinued operations.

Net loss before deemed dividend. Due to the factors cited above, we reported a net loss before deemed dividend of $9.2 million in 2003, compared to a net loss of $18.5 million in 2002, a decrease of $9.3 million, or 50%.

Net loss after deemed dividend of common stock to certain stockholders. Due to the factors cited above, we reported a net loss after deemed dividend of $9.6 million in 2003, compared to a net loss of $18.5 million in 2002, a decrease of $8.9 million, or 48%.

Liquidity and Capital Resources

As of December 31, 2004, we had $6.7 million in cash, $7.0 million in restricted collateral securities and restricted held-to-maturity securities due within one year, $4.0 million in long-term restricted deposits, and $136,000 in available-for-sale marketable securities, as compared to at December 31, 2003, when we had $13.7 million in cash and $706,000 in restricted cash deposits due within one year. The decrease in cash was primarily the result of the costs of the acquisitions of FAAC, Epsilor and AoA, and working capital needed in our other segments.

We used available funds in 2004 primarily for acquisitions, sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets by $1.7 million during the year ended December 31, 2004, primarily in the Battery and Power Systems Division and in the Simulation and Security Division. Our net fixed assets amounted to $4.6 million as at year end.

Net cash used in operating activities for 2004 and 2003 was $852,000 and $3.3 million, respectively, a decrease of $2.5 million, or 75%. This decrease was primarily the result of an increase in our adjusted net income in 2004 (net income in statement of operations less non-cash charges such as depreciation, amortization, non-cash financial expenses and non-cash expenses related to options and warrants).

Net cash used in investing activities for 2004 and 2003 was $50.5 million and $1.8 million, respectively, an increase of $48.7 million. This increase was primarily the result of our investment in the acquisition of FAAC, Epsilor and AoA in 2004.

Net cash provided by financing activities for 2004 and 2003 was $44.4 million and $17.4 million, respectively, an increase of $27.0 million, or

156%. This increase was primarily the result of higher amounts of funds raised through sales of our securities in 2004 compared to 2003.

During 2004, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately $1.1 million.

We have approximately $5.5 million in long-term debt outstanding (not including accrued severance pay), of which $4.5 million was related to convertible debt (unamortized financial expenses related to the beneficial conversion feature of these convertible debentures amounted to approximately $2.8 million at year end), and approximately $13.7 million in short-term debt (not including trade payables and other accounts payable), of which $13.4 million relates to the earn-out provision in connection with our acquisition of FAAC.

Our debt agreements contain customary affirmative and negative operations covenants that limit the discretion of our management with respect to certain business matters and place restrictions on us, including obligations on our part to preserve and maintain our assets and restrictions on our ability to incur or guarantee debt, to merge with or sell our assets to another company, and to make significant capital expenditures without the consent of the debenture holders, as well as granting to our investors a right of first refusal on any future financings, except for underwritten public offerings in excess of $30 million. We do not believe that this right of first refusal will materially limit our ability to undertake future financings.

Based on our internal forecasts, we believe that our present cash position and anticipated cash flows from operations should be sufficient to satisfy our current estimated cash requirements through at least the twelve months. This belief is based on certain assumptions that our management believes to be reasonable, some of which are subject to the risk factors detailed below. Over the long term, we will need to become profitable, at least on a cash-flow basis, and maintain that profitability in order to avoid future capital requirements. Additionally, we would need to raise additional capital in order to fund any future acquisitions.

Effective Corporate Tax Rate

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2002, 2003 and 2004, and accordingly no provision for income taxes was required. With respect to some of our U.S. subsidiaries that operated at a net profit during 2004, we were able to offset federal taxes against our net operating loss carryforward, which amounted to $23 million as of December 31, 2004. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. With respect to certain of our Israeli subsidiaries that operated at a net profit during 2004, we were unable to offset their taxes against our net operating loss carryforward, and we are therefore exposed to Israeli taxes, at a rate of up to 35% (less, in the case of companies that have "approved enterprise" status as discussed in Note 15 to the Notes to Financial Statements).

As of December 31, 2004, we had a U.S. net operating loss carryforward of approximately $23.0 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2009 through 2024, and foreign net operating and capital loss carryforwards of approximately $87.0 million, which are available indefinitely to offset future taxable income under certain circumstances.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2004, not including trade payables and other accounts payable:

	Payment Due by Period				
Contractual Obligations	**Total**	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More than 5 Years**
Long-term debt*	$ 5,558,391	$ –	$ 5,558,391	$ –	$ –
Short-term debt	$13,766,677	$13,766,677	$ –	$ –	$ –
Operating lease obligations	$ 1,427,965	$ 762,636	$ 641,017	$ 24,312	$ –
Severance obligations	$ 1,642,801	$ 223,333	$ 1,240,871	$ –	$ 178,597

* Includes convertible debentures in the gross amount of $4,537,500. Unamortized financial expenses related to the beneficial conversion feature of these convertible debentures amounted to $2,782,697 at year end.

** Includes sums owed in respect of an earn-out provision related to our acquisition of FAAC, in the amount of $13.4 million.

*** Includes obligations related to special severance pay arrangements in addition to the severance amounts due to certain employees pursuant to Israeli severance pay law.

Evaluation of Disclosure Controls and Procedures

As of December 31, 2004, our management, including the principal executive officer and principal financial officer, evaluated our disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in our periodic reports that we file with the SEC. These disclosure controls and procedures are intended to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers, by other of our employees, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Any system of controls and procedures, no matter how well designed and operated, can at best provide only reasonable assurance that the objective of the system are met and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met.

Based on their evaluation as of December 31, 2004, except as otherwise described herein and below, our principal executive officer and principal financial officer were able to conclude that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

In light of the material weakness described below, our management performed additional analyses and other post-closing procedures to ensure our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP). Accordingly, management believes that the consolidated financial statements included in this report fairly present in all material respects our financial position, results of operations and cash flows for the periods presented.

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. Our management has evaluated the effectiveness of our internal controls, pursuant to the requirements of Sarbanes-Oxley Section 404, as of the end of the period covered by this Annual Report. 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 *Internal Control – Integrated Framework*. In accordance with the rules of the SEC, we did not assess the internal control over financial reporting of Armour of America, Incorporated, which we acquired in August 2004, financial statements of which reflect total assets of 4% of our consolidated assets as of December 31, 2004, and total revenues of 5% of our consolidated revenues for the year then ended. In our Annual Report on Form 10-K for the year ending December 31, 2005, we will be required to provide an assessment of our compliance that takes into account an assessment of Armour of America, Incorporated and all of our other currently existing subsidiaries as of December 31, 2005.

For the reasons described below, we have concluded that there were material weaknesses in our internal controls at December 31, 2004. We note in this connection that our Independent Registered Public Accounting Firm audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), our consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2004, and their report dated March 24, 2005 expressed an unqualified opinion with respect thereto.

On November 22, 2004, the Audit Committee of our Board of Directors, on the recommendation of our management and after discussion with our Independent Registered Public Accounting Firm, made an internal determination and concluded that our Annual Report on Form 10-K for the year ended December 31, 2003, including the financial statements that our Independent Registered Public Accounting Firm had previously audited that are contained therein, contained certain errors related to the re-pricing of warrants and grant of additional warrants to certain of our investors and others and the amortization of debt discount arising from the allocation of the debt discount between the convertible debentures and their detachable warrants. The net effect of these errors, which generally related to the timing and characterization of certain non-cash expenses, was (i) to increase our net loss attributable to common stockholders for 2003 by approximately $579,000 and to decrease our net loss for the first half of 2004 by approximately $608,000, and (ii) to decrease our net loss attributable to common stockholders for the nine and three months ended September 30, 2004 by approximately $1,583,778 and $976,129, respectively. The Audit Committee of our Board of Directors therefore concluded to restate certain previously issued financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2003. The decision to restate these financial statements was made by our Audit Committee, upon the recommendation of our management and with the concurrence of our Independent Registered Public Accounting Firm.

As a result of the restatement referred to in the preceding paragraph, we have identified material weaknesses for inadequate controls related to the financial statement close process, convertible debentures and share capital processes as it applies to non-routine and highly complex financial transactions. A material weakness is a control deficiency (within the meaning of the Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2), or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The material weaknesses arise from insufficient staff with technical accounting expertise to independently apply our accounting policies, as they relate to non-routine and highly complex transactions, in accordance with U.S. generally accepted accounting principles. Management has identified that due to the reasons described above, we did not consistently follow established internal control over financial reporting procedures related to the analysis, documentation and review of selection of the appropriate accounting treatment for non-routine and highly complex transactions. Because of these material weaknesses, we have concluded that we did not maintain effective internal control over financial reporting as of December 31, 2004, based on the criteria in *Internal Control-Integrated Framework*.

The foregoing management assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004, has been audited by Kost, Forer, Gabbay and Kassierer, a member of Ernst & Young Global, the registered public accounting firm that audited the financial statements included in our annual report, as stated in their report which is included below.

Management's Response to the Material Weaknesses

In response to the material weaknesses described above, we have undertaken to take the following initiatives with respect to our internal controls and procedures that we believe are reasonably likely to improve and materially affect our internal control over financial reporting. We anticipate that remediation will be continuing throughout fiscal 2005, during which we expect to continue pursuing appropriate corrective actions, including the following:

- Preparing appropriate written documentation of our financial control procedures;
- Adding additional qualified staff to our finance department;
- Scheduling training for accounting staff to heighten awareness of generally accepted accounting principles applicable to complex transactions;
- Strengthening our internal review procedures in conjunction with our ongoing work to enhance our internal controls so as to enable us to identify and adjust items proactively;
- Engaging an outside accounting firm to support our Sarbanes-Oxley Section 404 compliance activities and to provide technical expertise in the selection and application of generally accepted accounting prin-

ciples related to complex transactions to identify areas that require control or process improvements and to consult with us on the appropriate accounting treatment applicable to complex transactions; and

- Implementing the recommendations of our outside accounting consultants.

Our management and Audit Committee will monitor closely the implementation of our remediation plan. The effectiveness of the steps we intend to implement is subject to continued management review, as well as Audit Committee oversight, and we may make additional changes to our internal control over financial reporting.

We cannot assure you that we will not in the future identify further material weaknesses in our internal control over financial reporting. We currently are unable to determine when the above-mentioned material weaknesses will be fully remediated. However, because remediation will not be completed until we have added finance staff and strengthened pertinent controls, we reported in our Quarterly Report on Form 10-Q for the first quarter of fiscal 2005 that material weaknesses continued to exist.

Changes in Internal Controls Over Financial Reporting

Except as noted above, there have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter to which this Annual Report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of

AROTECH CORPORATION

We have audited the accompanying consolidated balance sheets of Arotech Corporation (the "Company") and its subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in Item 15(a)(2) of the Company's 10-K. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits. We did not audit the financial statements of "Armor of America," a wholly-owned subsidiary of the Company, financial statements of which reflect total assets of 4% of the consolidated assets of the Company as of December 31, 2004, and total revenues of 5% of the consolidated revenues of the Company for the year then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the data included for this subsidiary, is based solely on the report of the other auditors.

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

In our opinion based on our audits and the other auditors the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles. Additionally, in our opinion the related financial statement schedule, when considered in relation to the basic financial statements and schedule taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1.b., the Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated for the matters set forth therein.

Tel Aviv, Israel
March 24, 2005

KOST, FORER, GABBAY & KASSIERER
A Member of Ernst & Young Global

ERNST & YOUNG

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of

AROTECH CORPORATION

We have audited management's assessment, included in the accompanying "Report of Management on Internal Control Over Financial Reporting," that Arotech Corporation did not maintain effective internal control over financial reporting as of December 31, 2004, because of the effect of material weaknesses in internal controls related to the financial statement close process, the convertible debentures and share capital processes as it applies to non-routine and highly complex financial transactions, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Arotech Corporation'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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

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

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

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

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment. Management identified material weaknesses for inadequate controls related to the financial statement close process, convertible debentures and share capital processes as it applies

to non-routine and highly complex financial transactions. The material weaknesses arise from insufficient staff with technical accounting expertise to independently apply the Company's accounting policies, as they relate to non-routine and highly complex transactions, in accordance with U.S. generally accepted accounting principles ("GAAP"). Management has identified that due to the reasons described above, the Company did not consistently follow established internal control over financial reporting procedures related to the analysis, documentation and review of selection of the appropriate accounting treatment for non-routine and highly complex transactions. These material weaknesses resulted in a restatement of the 2003 consolidated financial statements and quarterly unaudited consolidated financial statements for each of the quarters through September 30, 2004 and related to the errors in the appropriate accounting treatment to be applied to (i) re-pricing of warrants and grant of additional warrants to certain investors and others, and (ii) amortization of debt discount arising from the allocation of the debt discount between the convertible debentures and their detachable warrants. The net effect of these errors, which generally related to the timing and characterization of certain non-cash expenses, was (i) to increase net loss attributable to common stockholders for 2003 by approximately $579,000 and to decrease net loss for the first half of 2004 by approximately $608,000, and (ii) to decrease net loss attributable to common stockholders for the nine and three months ended September 30, 2004 by approximately $1,583,778 and $976,129, respectively. The above material weaknesses resulted in the material misstatement of amount of convertible debentures, finance expenses related to convertible debentures and stockholders' equity.

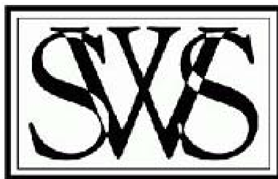
These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the December 31, 2004 consolidated financial statements, and this report does not affect our report dated March 24, 2005 on those consolidated financial statements.

As indicated in the accompanying "Report of Management on Internal Control Over Financial Reporting," management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Armour of America Inc., a wholly-owned subsidiary whose total assets and total revenues represent 4% and 5%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2004, which was acquired by the Company in a purchase business combination during 2004. Our audit of internal control over financial reporting of Arotech Corporation also did not include an evaluation of the internal control over financial reporting of Armour of America Inc.

In our opinion, management's assessment that Arotech Corporation did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO control criteria. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Arotech Corporation has not maintained effective internal control over financial reporting as of December 31, 2004, based on the COSO control criteria.

Tel Aviv, Israel
April 21, 2005

KOST, FORER, GABBAY & KASSIERER
A Member of Ernst & Young Global



STARK ♦ WINTER ♦ SCHENKEIN

Report of Independent Registered Public Accounting Firm

To the Shareholder
Armour of America, Inc.
Gardena, California

We have audited the accompanying balance sheets of Armour of America, Inc. as of December 31, 2004, and the related statements of income, stockholder's equity and cash flows for the period August 11, 2004 to December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Armour of America, Inc. as of December 31, 2004, and the results of its operations, stockholder's equity and cash flows for the period August 11, 2004 to December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ Stark Winter Schenkein & Co., LLP

Denver, Colorado
January 31, 2005

STARK ♦ WINTER ♦ SCHENKEIN & CO., LLP ♦ *Certified Public Accountants* ♦ *Financial Consultants*

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AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
In U.S. dollars

	December 31,	
	2004	**2003***
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 6,734,512	$ 13,685,125
Restricted collateral deposits and restricted held-to-maturity securities	6,962,110	706,180
Available for sale marketable securities	135,568	–
Trade receivables (net of allowance for doubtful accounts in the amounts of $55,394 and $61,282 as of December 31, 2004 and 2003, respectively)	8,266,880	4,706,423
Unbilled receivables	2,881,468	–
Other accounts receivable and prepaid expenses	1,339,393	1,187,371
Inventories	7,277,301	1,914,748
Assets of discontinued operations	–	66,068
Total current assets	33,597,232	22,265,915
SEVERANCE PAY FUND	1,980,047	1,023,342
RESTRICTED DEPOSITS	4,000,000	–
PROPERTY AND EQUIPMENT, NET	4,600,691	2,292,741
OTHER INTANGIBLE ASSETS, NET	14,368,701	2,375,195
GOODWILL	39,745,516	5,064,555
	$ 98,292,187	$ 33,021,748

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2004	**2003***
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 6,177,546	$ 1,967,448
Other accounts payable and accrued expenses	5,818,188	4,030,411 **
Current portion of promissory notes due to purchase of subsidiaries	13,585,325	150,000
Short term bank credit and current portion of long term loans	181,352	40,849
Deferred revenues	618,229	140,936 **
Liabilities of discontinued operations	–	380,108
Total current liabilities	26,380,640	6,709,752
LONG TERM LIABILITIES		
Accrued severance pay	3,422,951	2,814,492
Convertible debenture	1,754,803	1,450,194
Deferred revenues	163,781	220,143
Long term loan	20,891	–
Long-term portion of promissory note due to purchase of subsidiaries	980,296	150,000
Total long-term liabilities	6,342,722	4,634,829
COMMITMENTS AND CONTINGENT LIABILITIES (Note 12)		
MINORITY INTEREST	95,842	51,290
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – $0.01 par value each;		
Authorized: 250,000,000 shares and 100,000,000 shares as of December 31, 2004 and 2003, respectively; Issued: 80,576,902 shares and 47,972,407 shares as of December 31, 2004 and 2003, respectively; Outstanding – 80,021,569 shares and 47,417,074 shares as of December 31, 2004 and 2003, respectively	805,769	479,726
Preferred shares – $0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2004 and 2003; No shares issued and outstanding as of December 31, 2004 and 2003	–	–
Additional paid-in capital	189,266,704	135,702,413
Accumulated deficit	(118,953,553)	(109,911,240)
Deferred stock compensation	(1,258,295)	(8,464)
Treasury stock, at cost (common stock – 555,333 shares as of December 31, 2004 and 2003)	(3,537,106)	(3,537,106)
Notes receivable from stockholders	(1,222,871)	(1,203,881)
Accumulated other comprehensive income	372,335	104,429
Total stockholders' equity	65,472,983	21,625,877
	$ 98,292,187	$ 33,021,748

* Restated (see Note 1.b.).
** Reclassified.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
In U.S. dollars

	Year ended December 31,		
	2004	**2003***	**2002**
Revenues	$ 49,953,846	$ 17,326,641	$ 6,406,739
Cost of revenues	34,011,094	11,087,840	4,421,748
Gross profit	15,942,752	6,238,801	1,984,991
Operating expenses:			
Research and development, net	1,731,379	1,053,408	685,919
Selling and marketing expenses	4,922,217	3,532,636	1,309,669
General and administrative expenses	10,656,866	5,857,876	4,023,103
Amortization of intangible assets and impairment l	2,814,835	864,910	623,543
In-process research and development write-off	–	–	26,000
Total operating costs and expenses	20,125,297	11,308,830	6,668,234
Operating loss	(4,182,545)	(5,070,029)	(4,683,243)
Financial income (expenses), net	(4,228,965)	(4,038,709)	100,451
Loss before minorities interests in loss (earnings) of a subsidiaries and tax expenses	(8,411,510)	(9,108,738)	(4,582,792)
Income taxes	(586,109)	(396,193)	–
Minorities interests in loss (earnings) of subsidiaries	(44,694)	156,900	(355,360)
Loss from continuing operations	(9,042,313)	(9,348,031)	(4,938,152)
Income (loss) from discontinued operations (including loss on disposal of $4,446,684 during 2002)	–	110,410	(13,566,206)
Net loss	$ (9,042,313)	$ (9,237,621)	$(18,504,358)
Deemed dividend to certain stockholders	$ (3,328,952)	$ (350,000)	$ –
Net loss attributable to common stockholders	$(12,371,265)	$ (9,587,621)	$(18,504,358)
Basic and diluted net loss per share from continuing operations	$ (0.13)	$ (0.24)	$ (0.15)
Basic and diluted net loss per share from discontinued operations	$ 0.00	$ 0.00	$ (0.42)
Basic and diluted net loss per share	$ (0.18)	$ (0.25)	$ (0.57)
Weighted average number of shares used in computing basic and diluted net loss per share	69,933,057	38,890,174	32,381,502

* Restated (see Note 1.b.).

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Total comprehensive loss	Notes receivable from shareholders	Accumulated other comprehensive loss	Total shareholders' equity
	Shares	Amount								
Balance as of January 1, 2002	29,059,469	$290,596	$105,686,909	$(82,169,261)	$(18,000)	$(3,537,106)		$(845,081)	–	$ 19,408,057
Adjustment of notes from shareholders								(178,579)		(178,579)
Repayment of notes from employees	–	–	–	–	–	–		43,308		43,308
Issuance of shares to investors	2,041,176	20,412	3,209,588							3,230,000
Issuance of shares to service providers	368,468	3,685	539,068							542,753
Issuance of shares to lender in respect of prepaid interest expenses	387,301	3,873	232,377	–	–	–		–		236,250
Exercise of options by employees	191,542	1,915	184,435					(36,500)		149,850
Amortization of deferred stock compensation					6,000					6,000
Stock compensation related to options issued to employees	13,000	130	12,870							13,000
Issuance of shares in respect of acquisition	3,640,638	36,406	4,056,600							4,093,006
Accrued interest on notes receivable			160,737					(160,737)		–
Other comprehensive loss Foreign currency translation adjustment							(1,786)		(1,786)	(1,786)
Net loss				(18,504,358)			(18,504,358)			(18,504,358)
Total comprehensive loss							$ (18,506,144)			
Balance as of December 31, 2002	35,701,594	$ 357,017	$114,082,584	$(100,673,619)	$ (12,000)	$(3,537,106)		$(1,177,589)	$ (1,786)	$ 9,037,501

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Notes receivable from shareholders	Accumulated other comprehensive loss	Total comprehensive loss	Total shareholders' equity
	Shares	Amount								
Balance as of January 1, 2003*	35,701,594	$ 357,017	$114,082,584	$(100,673,619)	$ (12,000)	$(3,537,106)	$(1,177,589)	$ (1,786)		$ 9,037,501
Compensation related to warrants issued to the holders of convertible debentures			5,157,500							5,157,500
Compensation related to beneficial conversion feature of convertible debentures			5,695,543							5,695,543
Issuance of shares on conversion of convertible debentures	6,969,605	69,696	6,064,981				(9,677)			6,125,000
Issuance of shares on exercise of warrants	3,682,997	36,831	3,259,422							3,296,253
Issuance of shares to consultants	223,600	2,236	159,711							161,947
Compensation related to grant and reprcing of warrants and options issued to consultants			229,259							229,259
Compensation related to non-recourse loan granted to shareholder			38,500							38,500
Deferred stock compensation			4,750		(4,750)					–
Amortization of deferred stock compensation					8,286					8,286
Exercise of options by employees	689,640	6,896	426,668							433,564
Exercise of options by consultants	15,000	150	7,200							7,350
Conversion of convertible promissory note	563,971	5,640	438,720							444,360
Increase in investment in subsidiary against common stock issuance	126,000	1,260	120,960							122,220
Accrued interest on notes receivable from stockholders			16,615				(16,615)			–
Other comprehensive income – foreign currency translation adjustment								106,215	$ 106,215	106,215
Net loss				(9,237,621)					(9,237,621)	(9,237,621)
									$ (9,131,406)	
Balance as of December 31, 2003	47,972,407	$ 479,726	$135,702,413	$(109,911,240)	$ (8,464)	$(3,537,106)	$(1,203,881)	$ 104,429		$ 21,625,877

*Restated (see Note 1.b.).

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Notes receivable from shareholders	Accumulated other comprehensive loss	Total comprehensive loss	Total shareholders' equity
	Shares	Amount								
Balance as of January 1, 2004	47,972,407	$ 479,726	$135,702,413	$(109,911,240)	$ (8,464)	$(3,537,106)	$(1,203,881)	$ 104,429		$ 21,625,877
Issuance of shares, net	14,138,491	141,384	24,252,939							24,394,323
Issuance of shares and warrants due to settlement of litigation	450,000	4,500	1,244,328							1,248,828
Issuance of shares to employees	40,000	400	92,800							93,200
Conversion of convertible debentures	3,843,728	38,437	3,754,279							3,792,716
Exercise of warrants by investors and others	11,363,342	113,633	19,119,638							19,233,271
Issuance of shares to consultants	90,215	902	198,489							199,391
Reclassification to liability in connection with warrants granted			(10,841,020)							(10,841,020)
Reclassification of liability to equity related to the fair value of warrants			10,514,181							10,514,181
Compensation related to non-recourse loan granted to shareholder			(10,000)							(10,000)
Deferred stock compensation related to options and restricted stock	740,000	7,400	2,074,057		(2,081,457)					–
Amortization of deferred stock compensation					831,626					831,626
Exercise of options by employees	897,248	8,972	1,101,172							1,110,144
Exercise of options by consultants	37,615	376	50,799							51,175
Issuance of shares in respect of FAAC acquisition	1,003,856	10,039	1,993,639							2,003,678
Accrued interest on notes receivable from stockholders			18,990				(18,990)			–
Other comprehensive income – foreign currency translation adjustment								263,404	$ 263,404	263,404
Other comprehensive income – realized gain on available for sale marketable securities								4,502	4,502	4,502
Net loss				(9,042,313)					(9,042,313)	(9,042,313)
									$ (8,774,407)	
Balance as of December 31, 2004	80,576,902	$805,769	$189,266,704	$(118,953,553)	$(1,258,295)	$(3,537,106)	$(1,222,871)	$372,335		$65,472,983

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
In U.S. dollars

	Year ended December 31,		
	2004	**2003***	**2002**
Cash flows from operating activities:			
Net loss	$ (9,042,313)	$ (9,237,621)	$(18,504,358)
Less loss (profit) for the period from discontinued operations	–	(110,410)	13,566,206
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minorities interests in earnings (loss) of subsidiary	44,694	(156,900)	355,360
Depreciation	1,199,465	730,159	473,739
Amortization of intangible assets, capitalized software costs and impairment of intangible assets	2,888,226	879,311	623,543
Remeasurement of liability in connection to warrants granted	(326,839)	–	–
In-process research and development write-off	–	–	26,000
Accrued severance pay, net	(441,610)	3,693	(357,808)
Amortization of deferred stock compensation and compensation related to shares issued to employees	884,826	8,286	19,000
(Mark up) write-off of loans to stockholders	(32,397)	(12,519)	542,317
Write-off of inventories	121,322	96,350	116,008
Impairment of property and equipment	–	68,945	–
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature	4,142,109	3,928,237	–
Amortization of deferred charges related to convertible debentures issuance	222,732	483,713	–
Amortization of prepaid financial expenses	–	236,250	–
Stock-based compensation related to grant of new warrants and repricing of warrants granted to consultants	–	229,259	–
Stock-based compensation related to shares issued and to be issued to consultants and shares granted as a donation	89,078	161,947	–
Stock-based compensation related to non-recourse note granted to stockholder	(10,000)	38,500	–
Interest accrued on promissory notes due to acquisition	39,311	(66,793)	29,829
Interest accrued on restricted collateral deposits	(267,179)	–	(3,213)
Capital gain from sale of marketable securities	(4,247)	–	–
Amortization of premium related to restricted held to maturity securities	202,467	–	–
Capital gain from sale of property and equipment	(16,479)	(11,504)	(4,444)
Decrease (increase) in trade receivables	732,828	(820,137)	389,516
(Increase) decrease in other accounts receivable and prepaid expenses	(49,513)	40,520	257,218
Decrease in deferred tax assets	(89,823)	–	–
Increase in inventories	(2,040,854)	(193,222)	(520,408)
Increase in unbilled revenues	(1,581,080)	–	–
Decrease in deferred revenues	(91,271)	–	–
Decrease in trade payables	2,913,623	(986,022)	(62,536)
Increase (decrease) in other accounts payable and accrued expenses	(125,231)	1,677,668	(423,664)
Net cash used in operating activities from continuing operations (reconciled from continuing operations)	(638,155)	(3,012,290)	(3,477,695)
Net cash used in operating activities from discontinued operations (reconciled from discontinued operations)	(214,041)	(313,454)	(5,456,912)
Net cash used in operating activities	$ (852,196)	$ (3,325,744)	$ (8,934,607)

* Restated. (see Note 1.b.)

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars	Year ended December 31,		
	2004	2003*	2002
Cash flows from investing activities:			
Purchase of property and equipment	(1,659,688)	(580,949)	(314,876)
Increase in capitalized software costs	(365,350)	(209,616)	–
Loans granted to stockholders	(1,036)	(13,737)	(4,529)
Repayment of loans granted to stockholders	32,397	9,280	–
Proceeds from sale of property and equipment	114,275	16,753	8,199
Proceeds from sale of marketable securities	90,016	–	–
Investment in marketable securities	(89,204)	–	–
Acquisition of IES (1)	–	–	(2,958,083)
Acquisition of MDT (2)	–	–	(1,201,843)
Acquisition of Epsilor (3)	(7,190,777)	–	–
Acquisition of FAAC (4)	(12,129,103)	–	–
Acquisition of AoA (5)	(17,339,522)	–	–
Repayment of promissory notes related to acquisition of subsidiaries	(2,000,000)	(750,000)	–
Purchase of certain tangible and intangible assets	(150,000)	(196,331)	–
Increase in restricted cash and held to maturity securities	(9,809,091)	(72,840)	(595,341)
Net cash used in discontinued operations (purchase of property and equipment)	–	–	(290,650)
Net cash used in investing activities	(50,497,083)	(1,797,440)	(5,357,123)
Cash flows from financing activities:			
Proceeds from issuance of shares, net	24,361,750	(6,900)	3,230,000
Proceeds from exercise of options to employees and consultants	1,148,819	440,914	113,350
Proceeds from exercise of warrants	19,233,271	3,296,254	–
Proceeds from issuance of convertible debentures, net	–	13,708,662	–
Payment of interest and principal on notes receivable from stockholders	–	–	43,308
Profit distribution to minority	–	–	(412,231)
Long term loan received	69,638	–	–
Repayment of long term loan	(65,674)	–	–
Increase (decrease) in short term bank credit	(376,783)	(74,158)	108,659
Payment on capital lease obligation	(4,145)	(4,427)	(5,584)
Net cash provided by financing activities	44,366,876	17,360,345	3,077,502
Increase (decrease) in cash and cash equivalents	(6,982,403)	12,237,161	(11,214,228)
Cash erosion due to exchange rate differences	31,790	(9,562)	–
Cash and cash equivalents at the beginning of the year	13,685,125	1,457,526	12,671,754
Cash and cash equivalents at the end of the year	$ 6,734,512	$ 13,685,125	$ 1,457,526
Supplementary information on non-cash transactions:			
Issuance of shares and warrants against accrued expenses and restricted deposit	$ 1,310,394	$ –	$ –
Issuance of shares to consultants in respect of prepaid interest expenses	$ –	$ –	$ 236,250
Exercise of options against notes receivable	$ –	$ –	$ 36,500
Purchase of intangible assets against note receivable	$ –	$ 300,000	$ –
Increase of investment in subsidiary against issuance of shares of common stock	$ –	$ 123,480	$ –
Conversion of promissory note to shares of common stock	$ –	$ 450,000	$ –
Conversion of convertible debenture to shares of common stock	$ 3,837,500	$ 6,125,000	$ –
Benefit due to convertible debentures and warrants	$ –	$ 10,853,043	$ –
Accrual for earn out in regard to subsidiary acquisition	$ 13,435,325	$ –	$ –
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	$ 532,750	$ 39,412	$ 10,640
Taxes on income	$ 969,009	$ 527,053	$ 114,901

* Restated (see Note 1.b.).

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

(1) In July 2002, the Company acquired substantially all of the assets of I.E.S. Electronics Industries U.S.A., Inc. ("IES"). The net fair value of the assets acquired and the liabilities assumed, at the date of acquisition, was as follows:

Working capital, excluding cash and cash equivalents	$ 1,233,000
Property and equipment, net	396,776
Capital lease obligation	(15,526)
Technology	1,515,000
Existing contracts	46,000
Covenants not to compete	99,000
In process research and development	26,000
Customer list	527,000
Trademarks	439,000
Goodwill	4,032,726
	8,298,976
Issuance of shares	(3,653,929)
Issuance of promissory note	(1,686,964)
	$2,958,083

(2) In July 2002, the Company acquired 51% of the outstanding ordinary shares of MDT Protective Industries Ltd. ("MDT"). The fair value of the assets acquired and liabilities assumed, at the date of acquisition, was as follows:

Working capital, excluding cash and cash and cash equivalents	$ 350,085
Property, and equipment, net	139,623
Minority rights	(300,043)
Technology	280,000
Customer base	285,000
Goodwill	886,255
	1,640,920
Issuance of shares	(439,077)
	$ 1,201,843

(3) In January 2004, the Company acquired substantially all of the outstanding ordinary shares of Epsilor Electronic Industries, Ltd. ("Epsilor"). The net fair value of the assets acquired and the liabilities assumed, at the date of acquisition, was as follows:

Working capital, excluding cash and cash equivalents	$ (849,992)
Property and equipment	709,847
Intangible assets and goodwill	10,284,407
	10,144,262
Issuance of shares in respect to transaction costs	(12,500)
Issuance of promissory note *)	(2,940,985)
	$ 7,190,777

*) During 2004 an amount of $2,000,000 was repaid to the former shareholders of Epsilor.

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

(4) In January 2004, the Company acquired all of the outstanding common stock of FAAC Incorporated ("FAAC"). The net fair value of the assets acquired and the liabilities assumed at the date of acquisition was as follows:

Working capital, excluding cash and cash equivalents	$ 1,796,791
Property and equipment	263,669
Intangible assets and goodwill	25,507,646
	27,568,106
Accrual of earn out payment	(13,435,325)
Issuance of shares, net	(2,003,678)
	$ 12,129,103

(5) In August 2004, the Company acquired all of the outstanding common stock of Armour of America, Incorporated ("AoA"). The net fair value of the assets acquired and the liabilities assumed at the date of acquisition was as follows:

Working capital, excluding cash and cash equivalents	$ 3,219,728
Property and equipment	997,148
Intangible assets and goodwill	13,122,646
	$ 17,339,522

NOTE 1:– GENERAL

a. Arotech Corporation, f/k/a Electric Fuel Corporation ("Arotech" or the "Company") and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles, and in the design, development and commercialization of its proprietary zinc-air battery technology for electric vehicles and defense applications. The Company is primarily operating through IES Interactive Training, Inc. ("IES"), a wholly-owned subsidiary based in Littleton, Colorado; FAAC Corporation, a wholly-owned subsidiary based in Ann Arbor, Michigan, and FAAC's 80%-owned United Kingdom subsidiary FAAC Limited; Electric Fuel Battery Corporation, a wholly-owned subsidiary based in Auburn, Alabama; Electric Fuel Ltd. ("EFL") a wholly-owned subsidiary based in Beit Shemesh, Israel; Epsilor Electronic Industries, Ltd., a wholly-owned subsidiary located in Dimona, Israel; MDT Protective Industries, Ltd. ("MDT"), a majority-owned subsidiary based in Lod, Israel; MDT Armor Corporation, a majority-owned subsidiary based in Auburn, Alabama; and Armour of America, Incorporated, a wholly-owned subsidiary based in Los Angeles, California.

Revenues derived from the Company's largest customers in 2004, 2003 and 2002 are described in Note 18.

b. Restatement of previously-issued financial statements:

During management's review of the Company's interim financial statements for the period ended September 30, 2004 the Company, after discussion with and based on a new and revised review of accounting treatment by its independent auditors, conducted a comprehensive review of the re-pricing of warrants and grant of new warrants to certain of its investors and others during 2003 and 2004. As a result of that review, the Company, upon recommendation of management and with the approval of the Audit Committee of the Board of Directors after discussion with the Company's independent auditors, reconsidered the accounting related to these transactions and reclassified certain expenses as a deemed dividend, a non-cash item, instead of as general and administrative expenses due to the recognition of these transactions as capital transactions that should not be expensed. These restatements do not affect the balance sheet, the stockholders' equity or the cash flow statements. In addition and as a result of the remeasurement described above, the Company has reviewed assumptions used in the calculation of fair value of all warrants granted during the year 2003. As a result of this comprehensive review, the Company has decreased its general and administrative expenses in the amount of $150,000, related to errors found in the valuation of warrants granted in a litigation settlement.

In addition, during management's review of the Company's interim financial statements for the period ended September 30, 2004, the Company also reviewed its calculation of amortization of debt discount attributable to the beneficial conversion feature associated with the convertible debentures. As a result of this review, the Company found errors which increased its financial expenses in the amount of $568,000 for the year ended December 31, 2003. The errors were related to the amortization of debt discount attributable to the warrants and their related convertible debentures, whereby the Company understated the amount of amortization for the year ended December 31, 2003 attributable to certain of the convertible debentures. See Note 13.

Similar errors were also noted in the Company's interim financial statements in the three-month period ended June 30, 2003, the nine-month period ended September 30, 2003, and the three and six-month periods ended March 31 and June 30, 2004.

The impacts of these restatements with respect to the year ended December 31, 2003 are summarized below:

Statement of Operations Data:

	For the Year Ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
General and administrative expenses	$ 6,196,779	$ (338,903)	$ 5,857,876
Operating loss	5,408,932	(338,903)	5,070,029
Financial expenses, net	3,470,459	568,250	4,038,709
Loss from continuing operations	9,118,684	229,347	9,348,031
Net loss	9,008,274	229,347	9,237,621
Deemed dividend to certain stockholders of common stock	–	350,000	350,000
Net loss attributable to common stockholders	$ 9,008,274	$ 579,347	$ 9,587,621
Basic and diluted net loss per share from continuing operations	$ 0.23	$ 0.01	$ 0.24
Basic and diluted net loss per share	$ 0.23	$ 0.02	$ 0.25

Balance Sheet Data:

	For the Year Ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
Other accounts payable and accrued expenses	$ 4,180,411	$ (150,000)	$ 4,030,411
Total current liabilities	6,859,752	(150,000)	6,709,752
Convertible debenture	881,944	568,250	1,450,194
Total long-term liabilities	4,066,579	568,250	4,634,829
Additional paid-in capital	135,891,316	(188,903)	135,702,413
Accumulated deficit	(109,681,893)	(229,347)	(109,911,240
Total stockholders' equity	22,044,127	(418,250)	21,625,877

Cash Flow Data:

	For the Year Ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
Net loss	$ 9,008,274	$ 229,347	$ 9,237,621
Stock based compensation related to repricing of warrants granted to investors and the grant of new warrants	388,403	(188,903)	199,500
Increase in other accounts payable and accrued expenses	1,827,668	(150,000)	1,677,668
Amortization of compensation related to beneficial conversion feature and warrants issued to holders of convertible debentures	3,359,987	568,250	3,928,237

c. Acquisition of Epsilor:

In January 2004, the Company entered into a stock purchase agreement between itself and all of the shareholders of Epsilor Electronic Industries, Ltd. ("Epsilor"), pursuant to the terms of which the Company purchased all of the outstanding shares of Epsilor from Epsilor's existing shareholders. Epsilor develops and sells rechargeable and primary lithium batteries and smart chargers to the military, and to private industry in the Middle East, Europe and Asia.

The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities acquired were recorded at their estimated market values as of the date of acquisition, and results of Epsilor's operations have been included in the consolidated financial statements commencing the date of acquisition. The total consideration of $10,144,262 (including transaction costs) for the shares purchased consisted of (i) cash in the amount of $7,000,000, and (ii) a series of three $1,000,000 promissory notes, due on the first, second and third anniversaries of the agreement, which were recorded at their fair value of $2,940,985.

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition to Epsilor's net assets as follows:

Tangible assets acquired	2,239,848
Intangible assets	
Customer list	5,092,395
Goodwill	5,192,012
Liabilities assumed	(2,379,993)
Total consideration	$ 10,144,262

Customer list in the amount of $5,092,395 has a useful life of approximately ten years.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual impairment test. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

The value assigned to tangible, intangible assets and liabilities was determined as follows:

1. To determine the estimated market value of Epsilor's net current assets, property and equipment, and net liabilities, the "Cost Approach" was used. According to the valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.
2. The customer list is the asset that generates most of the Company's sales. Hence, the "Income Approach" was used to estimate its value, resulting in a value of $5,092,395.

See Note 1.h. for pro forma financial information.

d. Acquisition of FAAC:

In January of 2004, the Company entered into a stock purchase agreement with the stockholders of FAAC Incorporated ("FAAC"), pursuant to the terms of which it acquired all of the issued and outstanding common stock of FAAC, a provider of

driving simulators, systems engineering and software products to the United States military, government and private industry.

The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities were recorded at their estimated market values as of the date acquired, and results of FAAC's operations have been included in the consolidated financial statements commencing the date of acquisition. The consideration for the purchase consisted of (i) cash in the amount of $12.0 million, and (ii) the issuance of a total of 1,003,856 shares of our common stock, $0.01 par value per share, having a value of approximately $2.0 million. Additionally, there is an earn-out based on 2004 net pretax income, with an additional earn-out on the 2005 pretax income from certain specific and limited programs. Based on FAAC's 2004 net pretax income, the Company estimates its earn-out obligation at $13.4 million, of which $6.0 million was pre-paid into escrow in the form of restricted cash (See Note 3). In March 2005, the Company and the former stockholders of FAAC signed an agreement pursuant to which the Company will transfer the restricted cash to the former stockholders of FAAC by March 31, 2005, and will issue to the former stockholders of FAAC $10.0 million in Arotech stock by April 30, 2005, with such stock to be registered and sold on behalf of the former stockholders of FAAC by March 31, 2006 until the earn-out shall have been paid in full (with any remaining shares of Arotech stock after proceeds of the sales reach $7.4 million to be returned to the Company) ; should the proceeds of the sales be less than $7.4 million, the Company will pay any shortfall in cash). The total consideration of $27.6 million (including the earn-out as well as $135,131 of transaction costs) was determined based upon arm's-length negotiations between the Company and FAAC's stockholders.

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition to FAAC's assets and liabilities as follows:

Tangible assets acquired	$	4,833,553
Intangible assets		
Technology		4,610,000
Backlog		636,000
Customer list		1,125,000
Trademarks		374,000
Goodwill		18,762,646
Liabilities assumed		(2,770,843)
Total consideration	$	27,570,356

Intangible assets which are subject to amortization, excluding trademarks, which are not subject to amortization, in the amount of $6,371,000 have a weighted-average useful life of approximately eight years.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual impairment test. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

The value assigned to tangible, intangibles assets and liabilities was determined as follows:

1. To determine the estimated fair value of FAAC's net current assets, property and equipment, and net liabilities, the "Cost Approach" was used. According to the valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.
2. The amount of the cost attributable to technology of the software, documentation and know-how that drives the vehicle simulators and the high-speed missile fly-out simulators is $4,610,000 and was determined using the "Income Approach."
3. FAAC's sales are all made on a contractual basis, most of which are over a relatively long period of time. At the date of the purchase FAAC had several signed contracts at various stages of completion. The value of the existing contracts was determined using the Income approach and resulting in a value of $636,000.
4. FAAC's customer list includes various branches of the U.S. military, major defense contractors, various city and country governments and others. Since customer relationship represent one of the most important revenue generating assets for FAAC, its value was estimated using the Income Approach, resulting in a value of $1,125,000.
5. FAAC's trade name value represents the name recognition value of the FAAC

brand name as a result of advertising spending by the company. The Cost Approach was used to determine the value of FAAC's trade name in the amount of $374,000.

See Note 1.h. for pro forma financial information.

e. Acquisition of AoA:

In August 2004, the Company purchased all of the outstanding stock of Armour of America, Incorporated, a California corporation ("AoA"), from AoA's existing shareholder. The assets acquired through the purchase of all of AoA's outstanding stock consisted of all of AoA's assets, including AoA's current assets, property and equipment, and other assets (including intangible assets such as intellectual property and contractual rights).

The total purchase price consisted of $19,000,000 in cash, with additional possible earn-outs if AoA is awarded certain material contracts. An additional $3,000,000 was to be paid into an escrow account pursuant to the terms of an escrow agreement, to secure a portion of the Earnout Consideration. Pursuant to the purchase agreement, the total consideration, sale price plus Earnout Consideration, will not be in excess of $40,000,000. When the contingency on the earn-out provision is resolved, the additional consideration, if any, will be recorded as additional purchase price. The purchase price also included $121,192 of transaction costs. The transaction has been accounted for using the purchase method of accounting, and accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based upon their fair values at the date the acquisition was completed.

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition to AoA's assets and liabilities as follows :

Tangible assets acquired	$	6,346,316
Intangible assets		
Certifications		246,969
Backlog		1,512,000
Customer relationships		490,000
Tradename /Trademark		70,000
Covenants not to compete		260,000
Goodwill		10,543,677
Liabilities assumed		(347,770)
Total consideration	$	19,121,192

Intangible assets, excluding trademarks, which are not subject to amortization, in the amount of $2,508,969 have a weighted-average useful life of approximately two years.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual impairment test. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

See Note 1.h. for pro forma financial information.

f. Acquisition of IES:

In August 2, 2002, the Company entered into an asset purchase agreement among I.E.S. Electronics Industries U.S.A., Inc. ("IES"), its direct and certain of its indirect shareholders, and its wholly-owned Israeli subsidiary, EFL, pursuant to the terms of which it acquired substantially all the assets, subject to substantially all the liabilities, of IES, a developer, manufacturer and marketer of advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel. The Company intends to continue to use the assets purchased in the conduct of the business formerly conducted by IES (the "Business"). The acquisition has been accounted under the purchase method of accounting. Accordingly, all assets and liabilities were acquired as at the values on such date, and the Company consolidated IES's results with its own commencing at such date.

The assets purchased consisted of the current assets, property and equipment, and other intangible assets used by IES in the conduct of the Business. The consideration for the assets and liabilities purchased consisted of (i) cash and promissory notes in an aggregate amount of $4,800,000 ($3,000,000 in cash and $1,800,000 in promissory notes, which was recorded at its fair value in the amount of $1,686,964) (see Note 10), and (ii) the issuance, with registration rights, of a total of 3,250,000 shares of our common stock, $.01 par value per share, having a value of approximately $3,653,929, which shares are the subject of a voting agreement on the part of IES and certain of its affiliated companies. The value of 3,250,000 shares issued was determined based on the average market price of Arotech's Common stock over the period including two days before and after the terms of

the acquisition were agreed to and announced. The total consideration of $8,354,893 (including $14,000 of transaction costs) was determined based upon arm's-length negotiations between the Company and IES and IES's shareholders.

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition to IES's assets as follows:

Tangible assets acquired	$ 2,856,951
Intangible assets	
Technology	1,515,000
Existing contracts	46,000
Covenants not to compete	99,000
In process research and development	26,000
Customer list	527,000
Trademarks	439,000
Goodwill	4,032,726
Liabilities assumed	(1,186,784)
Total consideration	$ 8,354,893

In September 2003, the Company's IES subsidiary purchased selected assets of Bristlecone Corporation. The assets purchased consisted of inventories, customer lists, and certain other assets (including intangible assets such as intellectual property and customer lists), including the name "Bristlecone Training Products" and the patents for the Heads Up Display (HUD) and a remote trigger device, used by Bristlecone in connection with its designing and manufacturing firearms training devices, for a total consideration of $183,688 in cash and $300,000 in promissory notes, payable in four equal semi-annual payments of $75,000 each, to become due and payable on March 1, 2004, August 31, 2004, February 28, 2005 and August 31, 2005. The acquired patents are used in the IES's Range FDU (firearm diagnostics unit).

The purchase consideration was estimated as follows:

Cash consideration	$ 183,688
Present value of promissory notes	289,333
Transaction expenses	12,643
Total consideration	$ 485,664

Based upon a valuation of tangible and intangible assets acquired, the Company has allocated the total cost of the acquisition of Bristlecone's assets as follows:

Tangible assets acquired	$ 33,668
Intangible assets	
Technology and patents	436,746
Customer list	15,250
Total consideration	$ 485,664

The Company believes that the acquisition of Bristlecone is not material to its business.

g. Acquisition of MDT:

On July 1, 2002, the Company entered into a stock purchase agreement with all of the shareholders of M.D.T. Protective Industries Ltd. ("MDT"), pursuant to the terms of which the Company purchased 51% of the issued and outstanding shares of MDT, a privately-held Israeli company that specializes in using sophisticated lightweight materials and advanced engineering processes to armor vehicles. The Company also entered into certain other ancillary agreements with MDT and its shareholders and other affiliated companies. The Acquisition was accounted under the purchase method accounting and results of MDT's operations have been included in the consolidated financial statements since that date. The total consideration of $1,767,877 for the shares purchased consisted of (i) cash in the aggregate amount of 5,814,000 New Israeli Shekels ($1,231,780), and (ii) the issuance, with registration rights, of an aggregate of 390,638 shares of our common stock, $0.01 par value per share, having a value of approximately $439,077. The value of 390,638 shares issued was determined based on the average market price of Arotech's Common stock over the period including two days before and after the terms of the acquisition were agreed to and announced.

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition to MDT's assets as follows:

Tangible assets acquired	$ 1,337,048
Intangible assets	
Technology	280,000
Customer base	285,000
Goodwill	886,255
Liabilities assumed	(1,020,426)
Total consideration	$ 1,767,877

In September 2003, the Company increased its holdings in both of its vehicle armoring subsidiaries. The Company now holds 88% of MDT Armor Corporation (compared to 76% before this transaction) and 75.5% of MDT Protective Industries Ltd. (compared to 51% before this transaction). The Company acquired the additional stake in MDT from AGA Means of Protection and Commerce Ltd. in exchange for the issuance to AGA of 126,000 shares of its common stock, valued at $0.98 per share based on the closing price of the Company's common stock on the closing date of September 4, 2003, or a

total of $123,480. Of this amount, a total of $75,941 was allocated to intangible assets. The Company did not obtain a valuation due to the immaterial nature of this acquisition.

h. Pro forma results:

In January 2004, the Company acquired FAAC and Epsilor, as more fully described in "Note 1.c. – Acquisition of Epsilor" and "Note 1.d. – Acquisition of FAAC," above, in August 2004, the Company acquired AoA, as more fully described in "Note 1.e. – Acquisition of AoA," above (the "Acquisitions") and in the year 2002 the Company acquired IES and MDT as more fully described in Note 1.f and Note 1.g (the "2002 Acquisitions"). The following summary pro forma information includes the effects of the Acquisitions on the operating results of the Company. The following unaudited pro forma data for 2004 and 2003 are presented as if the Acquisitions had been completed on January 1, 2004 and 2003, respectively. The unaudited pro forma data for 2002 are presented as if 2002 Acquisitions had been completed on January 1, 2002.

This pro forma financial information does not purport to be indicative of the results of operations that would have occurred had the Acquisitions taken place at the beginning of the period, nor do they purport to be indicative of the results of operations that will be obtained in the future.

	Year Ended December 31,		
	2004	2003*	2002
		(Unaudited)	
Total revenues	$ 61,086,697	$ 39,680,394	$ 12,997,289
Gross profit	22,528,254	17,214,249	4,424,952
Net loss	(5,810,114)	(6,959,174)	(6,103,771)
Deemed dividend of common stock attributable to certain stockholders	(3,328,952)	(350,000)	–
Net loss attributable to stockholders of common stock	$ (9,139,066)	$ (7,309,174)	$ (6,103,771)
Basic and diluted net loss per share	$ (0.13)	$ (0.14)	$ (0.18)
Weighted average number of shares used in computing basic net loss per share	69,933,057	52,966,330	34,495,185

* Restated.

i. Discontinued operations:

In September 2002, the Company committed to a plan to discontinue the operations of its retail sales of consumer battery products. The Company ceased the operation and disposed of all assets related to this segment by an abandonment. The operations and cash flows of consumer battery business have been eliminated from the operations of the Company as a result of the disposal transactions. The Company has no intent of continuing its activity in the consumer battery business. The Company's plan of discontinuance involved (i) termination of all employees whose time was substantially devoted to the consumer battery line and who could not be used elsewhere in the Company's operations, including payment of all statutory and contractual severance sums, by the end of the fourth quarter of 2002, and (ii) disposal of the raw materials, equipment and inventory used exclusively in the consumer battery business, since the Company has no reasonable expectation of being able to sell such raw materials, equipment or inventory for any sum substantially greater than the cost of disposal or shipping, by the end of the first quarter of 2003. The Company had previously reported its consumer battery business as a separate segment (Consumer Batteries) as called for by Statement of Financial Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS No. 131").

The results of operations including revenue, operating expenses, other income and expense of the retail sales of consumer battery products business unit for 2003 and 2002 have been reclassified in the accompanying statements of operations as a discontinued operation. The Company's balance sheets at December 31, 2003 reflect the net liabilities of the retail sales of consumer battery products business as net liabilities and net assets of discontinued operation within current liabilities and current assets.

At December 31, 2002, the estimated net losses associated with the disposition of the retail sales of consumer battery products business were $13,566,206 for 2002. These losses included approximately $6,508,522 in losses from operations for the period from January 1, 2002 through the measurement date of December 31, 2002 and $7,057,684, reflecting a write-down of inventory and net property and equipment of the retail sales of consumer battery products business, as follows:

	December 31, 2002
Write-off of inventories	$ 2,611,000
Impairment of property and equipment	4,446,684
	$ 7,057,684

As a result of the discontinuance of consumer battery segment, the Company ceased to use property and equipment related to this segment. In accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long- Lived Assets" ("SFAS No. 144") such assets was considered to be impaired. The impairment to be recognized was measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Obligations to employees for severance and other benefits resulting from the discontinuation have been reflected in the financial statements on an accrual basis.

Summary operating results from the discontinued operation for the years ended December 31, 2004, 2003 and 2002 are as follows:

	Year Ended December 31,		
	2004	2003	2002
Revenues	–	$ 117,267	$ 1,100,442
Cost of sales [1]	–	–	(5,293,120)
	–		
Gross loss	–	117,267	(4,192,678)
Operating expenses	–	6,857	4,926,844
Impairment of fixed assets	–	–	4,446,684
Operating loss	–	$ 110,410	$(13,566,206)

[1] Including write-off of inventory in the amount of $0, $0 and $2,611,000 for the years ended December 31, 2004, 2003 and 2002.

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. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles 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.

b. Financial statements in U.S. dollars:

A majority of the revenues of the Company and most of its subsidiaries is generated in U.S. dollars. In addition, a substantial portion of the Company's and most of its subsidiaries costs are incurred in U.S. dollars ("dollar"). Management believes that the dollar is the primary currency of the economic environment in which the Company and most of its subsidiaries operate. Thus, the functional and reporting currency of the Company and most of its subsidiaries is the dollar. Accordingly, monetary accounts maintained in currencies other than the U.S. dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transaction, gains and losses from the remeasured monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

The majority of transactions of MDT and Epsilor are in New Israel Shekel ("NIS") and a substantial portion of MDT's and Epsilor's costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT and Epsilor. Accordingly, the financial statements of MDT and Epsilor have been translated into U.S. dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts has been translated using the weighted average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive loss in stockholders' equity

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly and majority owned subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation.

d. Cash equivalents:

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

e. Restricted collateral deposits:

Restricted cash is primarily invested in highly liquid deposits, held-to-maturity marketable securities and long-term deposits, which are used as a security for the Company's guarantee performance and its liability to former shareholders of its acquired subsidiaries.

f. Marketable securities:

The Company and its subsidiaries account for investments in debt and equity securities in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain In-

vestments in Debt and Equity Securities" ("SFAS No. 115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

At December 31, 2004 the Company and its subsidiaries classified its investment in marketable securities as held-to-maturity and available-for-sale.

Debt securities are classified as held-to-maturity, when the Company has the positive intent and ability to hold the securities to maturity, and are stated at amortized cost. The cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization, accretion and interest are included in financial income, net.

Investment in trust funds are classified as available-for-sale and stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of income.

g. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence and for market prices lower than cost. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are made to write inventory down to its market value. In 2002, 2003 and 2004, the Company wrote off $116,008, $96,350 and $121,322 of obsolete inventory respectively, which has been included in the cost of revenues.

Cost is determined as follows:

Raw and packaging materials – by the average cost method.

Work in progress – represents the cost of manufacturing with the addition of allocable indirect manufacturing cost.

Finished products – on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

h. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants (no investment grants were received during 2004, 2003 and 2002).

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

	%
Computers and related equipment	33
Motor vehicles	15
Office furniture and equipment	6 - 10
Machinery, equipment and installation	10 - 25 (mainly 10)
Leasehold improvements	By the shorter of the term of the lease and the life of the asset

i. Goodwill:

Goodwill represents the excess of cost over the fair value of the net assets of businesses acquired. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No, 142") goodwill acquired in a business combination on or after July 1, 2001, is not amortized after January 1, 2002.

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units.

The Company performed the required annual impairment test of goodwill. Based on the management projections and using expected future discounted operating cash flows, no indication of goodwill impairment was identified.

j. Long-lived assets:

Intangible assets acquired in a business combination that are subject to amortization are amortized over their useful life using a method of amortization that reflects the pattern in which the

economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142.

The acquired trademarks and tradenames are deemed to have an indefinite useful life because they are expected to contribute to cash flows indefinitely. Therefore, the trademarks will not be amortized until their useful life is no longer indefinite. The trademarks and tradenames are tested annually for impairment in accordance FAS 142.

The Company and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2004 the Company identified an impairment of the technology previously purchased from Bristlecone and as a result has recorded an impairment loss in the amount of $320,000.

k. Revenue recognition:

The Company is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. During 2004, the Company and its subsidiaries recognized revenues as follows: (i) from the sale and customization of interactive training systems and from the maintenance services in connection with such systems (Interactive Training Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery Division); and (iv) from the sale of lifejacket lights (Battery Division.

Revenues from the Battery division products and Armor division are recognized in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probably, and no further obligation remains.

Revenues from products not delivered upon customers' request due to lack of storage space at the customers' facilities during the integration are recognized when the criteria of Staff Accounting Bulletin No. 104 ("SAB No. 104") for bill-and-hold transactions are met.

Revenues from contracts that involve customization of FAAC's simulation system to customer specific specifications are recognized in accordance with Statement Of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," using contract accounting on a percentage of completion method, in accordance with the "Input Method." The amount of revenue recognized is based on the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual time incurred to date in the project compared to the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2004 no such estimated losses were identified.

The Company believes that the use of the percentage of completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and the terms of settlement, including in cases of terminations for convenience. In all cases the Company expects to perform its contractual obligations and its customers are expected to satisfy their obligations under the contract.

Revenues from simulators, which do not require significant customization, are recognized in accordance with Statement of Position 97-2, "Software Revenue Recognition," ("SOP 97-2"). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has adopted Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions" ("SOP 98-9"). According to SOP No. 98-9, revenues are allocated to the different elements in the arrangement under the "residual method" when Vendor Specific Objective Evidence ("VSOE") of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the residual method, at the outset of the arrangement with the customer, the Company defers revenue for the fair value of its undelivered elements (maintenance and support) and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (software product) when all other criteria in SOP 97-2 have been met.

Revenue from such simulators is recognized when persuasive evidence of an agreement exists, delivery has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectibility is probable.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support services. Revenues from training are recognized when its performed. The VSOE of fair value of the maintenance, training and support services is determined based on the price charged when sold separately or when renewed.

Unbilled receivables include cost and gross profit earned in excess of billing.

Deferred revenues include unearned amounts received under maintenance and support services and billing in excess of costs and estimated earnings on uncompleted contracts.

l. Right of return:

When a right of return exists, the Company defers its revenues until the expiration of the period in which returns are permitted.

m. Research and development cost:

Research and development costs, net of grants received, are charged to the statements of operations as incurred.

Software development costs incurred by the Company's subsidiaries between completion of the working model and the point at which the product is ready for general release, are capitalized.

Capitalized software costs are amortized by using the straight-line method over the estimated useful life of the product (three to five years). The Company assesses the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through future gross revenues from the specific software product sold. Based on its most recent analyses, management identified an impairment of software development costs previously capitalized and as a result has recorded an impairment loss in the amount of $26,000.

n. Income taxes:

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This Statement prescribes the use of the liability method, whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to it's estimated realizable value.

o. Concentrations of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, restricted collateral deposit and restricted held-to-maturity securities, trade receivables and available for sale marketable securities. Cash and cash equivalents are invested mainly in U.S. dollar deposits with major Israeli and U.S. 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 and its subsidiaries are mainly derived from sales to customers located primarily in the United States, Europe and Israel. 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. An allowance for doubtful accounts is determined with respect to those accounts that the Company has determined to be doubtful of collection.

The Company's available for sale marketable securities and held-to-maturity securities include investments in debentures of U.S. and Israeli corporations and state and local governments. Management believes that those corporations and states are institutions that are financially sound, that the portfolio is well diversified, and accordingly, that minimal credit risk exists with respect to these marketable securities.

The Company and its subsidiaries had no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

p. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year. Diluted net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year, plus dilutive potential shares of common stock considered outstanding during the year, in accordance with Statement of Financial Standards No. 128, "Earnings Per Share."

All outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share was 31,502,158, 22,194,211 and 4,394,803 for the years ended December 31, 2004, 2003 and 2002, respectively.

q. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB No. 25") and Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized. Under Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), pro-forma information regarding net income and net income per share is required, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123.

The Company applies SFAS No. 123 and Emerging Issue Task Force No. 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

The fair value for the options to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 3.63%, 2.54% and 3.5% for 2004, 2003 and 2002, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the common stock of 0.81 for 2004, 0.67 for 2003 and 0.64 for 2002; and a weighted-average expected life of the option of 5 years for 2004, 2003 and 2002.

The following table illustrates the effect on net income and earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS No. 123 on its stock-based employee compensation:

	Year ended December 31,		
	2004	2003*	2002
Net loss as reported	$ (9,042,313)	$ (9,237,621)	$ (18,504,358)
Add: Stock-based compensation expenses included in reported net loss	831,626	8,286	6,000
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(2,741,463)	(1,237,558)	(2,072,903)
	$ (10,952,150)	$ (10,466,893)	$ (20,571,261)
Loss per share:			
Basic and diluted, as reported	$ (0.18)	$ (0.25)	$ (0.57)
Diluted, pro forma	$ (0.16)	$ (0.27)	$ (0.64)

* Restated (see Note 1.b.).

r. Fair value of financial instruments:

The following methods and assumptions were used by the Company and its subsidiaries in estimating their fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, restricted collateral deposit and restricted held-to-maturity securities, trade receivables, short-term bank credit, and trade payables approximate their fair value due to the short-term maturity of such instruments.

The fair value of available for sale marketable securities is based on the quoted market price.

Long-terms promissory notes are estimated by discounting the future cash flows using current interest rates for loans or similar terms and maturities. The carrying amount of the long-term liabilities approximates their fair value.

s. Severance pay:

The Company's liability for severance pay 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 employees is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

In addition and according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. The Company has made a provision for this special severance pay in accordance with Statement of Financial Accounting Standard No. 106, "Employer's Accounting for Post Retirement Benefits Other than Pensions." As of December 31, 2004 and 2003, the accumulated severance pay in that regard amounted to $1,642,801 and $1,699,260, respectively.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies and includes immaterial profits.

Severance expenses for the years ended December 31, 2004, 2003 and 2002 amounted to $460,178, $219,857 and ($338,574) respectively.

t. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2004, 2003 and 2002 was approximately $13,271, $34,732 and $294,599, respectively.

u. New accounting pronouncements:

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), "Share-Based Payment," which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation." Statement 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends FASB Statement No. 95, "Statement of Cash Flows." Generally, the approach in

Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

Statement 123(R) must be adopted no later than July 1, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt Statement 123(R) on the first interim period beginning after July 1, 2005.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company is still in the process of evaluating the method it will use.

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R)'s fair value method will have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in Note 2r above to the Company's consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature.

In November 2004, the FASB issued Statement of Financial Accounting Standard No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4.." SFAS 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SAFS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company is still in the process of the evaluating the impact of the adoption of SFAS 151 on its financial position or results of operations.

NOTE 3:– RESTRICTED COLLATERAL DEPOSITS AND RESTRICTED HELD-TO-MATURITY SECURITIES:

	December 31,	
	2004	2003
Short-term:		
Restricted, held to maturity, bonds in connection with FAAC earn out (Note 1.d.)[(1)]	$ 5,969,413	$ –
IES deposit in connection to the Company's litigation with IES Electronics Industries Ltd.	–	450,000
Deposits in connection with FAAC projects	650,989	–
Forward Deal	–	205,489
Property lease	–	41,412
Other	341,708	9,279
Total short-term	6,962,110	706,810
Long-term:	3,000,000	–
Restricted cash in connection with AoA earn out (Note 1.e.)	1,000,000	–
Restricted deposit in connection with Epsilor acquisition (Note 1.c.)	4,000,000	–
Total long-term	$10,962,110	$ 706,180

(1) The following is a summary of held-to-maturity securities at December 31, 2004 and 2003:

	Amortized cost		Unrealized losses		Estimated fair value	
	2004	2003	2004	2003	2004	2003
Obligations of States and political subdivisions	$1,012,787	$ –	$ (1,870)	$ –	$1,010,917	$ –
Corporate obligations	4,956,626	–	(11,966)	–	4,944,660	–
	$5,969,413	$ –	$ (13,836)	$ –	$5,955,577	$ –

The amortized cost of held-to-maturity debt securities at December 31, 2004, by contractual maturities, is shown below*:*

	Amortized cost	Unrealized losses	Estimated fair value
Due in one year or less	$5,969,413	$ (13,836)	$ 5,955,577

The unrealized losses in the Company's investments were caused by interest rate increases. It is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Based on the immaterial severity of the impairments and the obligation of the Company to hold these investments until maturity, the bonds were not considered to be other than temporarily impaired at December 31, 2004.

NOTE 4:– AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2004 and 2003:

	Cost		Unrealized gains		Estimated fair value	
	2004	2003	2004	2003	2004	2003
Available for sale marketable securities	$ 130,061	$ –	$ 5,507	$ –	$ 135,568	$ –

NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2004	2003
Government authorities	$ 433,427	$ 65,402
Employees	217,948	246,004
Prepaid expenses	490,357	551,010
Deferred taxes	135,482	–
Other	62,179	324,955
	$ 1,339,393	$ 1,187,371

NOTE 6:– INVENTORIES

	December 31,	
	2004	2003
Raw and packaging materials	$ 3,969,400	$ 657,677
Work in progress	1,996,139	634,221
Finished products	1,311,762	622,850
	$ 7,277,301	$ 1,914,748

NOTE 7:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2004	2003
Cost:		
Computers and related equipment	$ 3,374,695	$ 1,015,836
Motor vehicles	653,255	288,852
Office furniture and equipment	872,804	402,726
Machinery, equipment and installations	7,464,470	4,866,904
Leasehold improvements	1,321,025	882,047
Demo inventory	141,961	150,996
	13,828,210	7,607,361
Accumulated depreciation:		
Computers and related equipment	2,581,689	753,593
Motor vehicles	197,071	95,434
Office furniture and equipment	494,181	173,301
Machinery, equipment and installations	5,143,186	3,637,111
Leasehold improvements	811,392	655,181
	9,227,519	5,314,620
Depreciated cost	$ 4,600,691	$ 2,292,741

b. Depreciation expense amounted to $1,199,465, $730,159 and $473,739, for the years ended December 31, 2004, 2003 and 2002, respectively.

As for liens, see Note 12.d.

NOTE 8:– OTHER INTANGIBLE ASSETS, NET

a.

	Year ended December 31,	
	2004	2003
Cost:		
Technology	$ 6,841,746	$ 2,231,746
Capitalized software costs	574,967	209,615
Backlog	2,194,000	46,000
Covenants not to compete	359,000	99,000
Customer list	7,548,645	827,250
Certification	246,969	–
	17,765,327	3,413,611
Exchange differences	125,455	25,438
Less - accumulated amortization	(4,391,081)	(1,502,854)
Amortized cost	13,499,701	1,936,195
Trademarks	869,000	439,000
	$14,368,701	$ 2,375,195

b. Amortization expenses amounted to $2,888,226, $879,311 and $623,543 for the years ended December 31, 2004, 2003 and 2002.

c. Estimated amortization expenses, except capitalized software costs, for the years ended

Year ended December 31,	
2005	$ 3,280,815
2006	2,073,209
2007	1,381,883
2008	1,276,075
2009 and forward	5,000,546
	$13,012,528

NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS

The Company has a $3.2 million authorized credit line from certain banks, of which $209,000 is denominated in NIS and carries an interest rate of approximately prime + 2.5% and $3.0 million of which is denominated in dollars and carries an interest rate of prime + 0.25%. As of December 31, 2004, $2.1 million was utilized, out of which $2.0 million is related to letter of credit issued to one of the customers of one of the Company's subsidiaries.

This line of credit is secured by the accounts receivable, inventory and marketable securities of the relevant subsidiary of the Company.

In addition the Company has two automobile purchase loans, of which the later one will be repaid in June 2006. Those loans are denominated in NIS and carry an interest rate of 5.2%-6.2%. Each loan is secured by the automobile purchased with the proceeds of the loan.

NOTE 10:– PROMISSORY NOTES

In connection with the acquisition of IES, the Company issued promissory notes in the face amount of an aggregate of $1,800,000, one of which was a note for $400,000 that was convertible into an aggregate of 200,000 shares of the Company's common stock. The Company has accounted for these notes in accordance with Accounting Principles Board Opinion No. 21, "Interest on Receivables and Payables," and recorded the notes at their present value in the amount of $1,686,964. In December 2002, the terms of these promissory notes were amended to (i) extinguish the $1,000,000 note due at the end of June 2003 in exchange for prepayment of $750,000, (ii) amend the $400,000 note due at the end of December 2003 to be a $450,000 note, and (iii) amend the convertible $400,000 note due at the end of June 2004 to be a $450,000 note convertible at $0.75 as to $150,000, at $0.80 as to $150,000, and at $0.85 as to $150,000. In accordance with EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," the terms of promissory notes were not treated as changed or modified as the cash flow effect on a present

value basis was less than 10%. The $450,000 note due at the end of June 2004 was converted into an aggregate of 563,971 shares of common stock in August 2003. With reference to the $450,000 note due at the end of December 2003, see Note 14.f.6.

NOTE 11:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2004	2003*
Employees and payroll accruals	$ 1,534,295	$ 1,232,608
Accrued vacation pay	469,527	216,768
Accrued expenses	1,770,348	842,760
Minority balance	243,116	149,441
Government authorities	1,036,669	357,095
Litigation settlement accrual[(1)]	–	1,163,642
Advances from customers	746,819	–
Other	17,414	68,097
	$ 5,818,188	$ $ 4,030,411

* Restated (see Note 1.b.).
(1) See Note 14.f.6.

NOTE 12:– COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

1. Under EFL's research and development agreements with the Office of the Chief Scientist ("OCS"), and pursuant to applicable laws, EFL is required to pay royalties at the rate of 3%-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 (linked to the U.S. dollars. Amounts due in respect of projects approved after year 1999 also bear interest at the Libor rate). EFL is obligated to pay royalties only on sales of products in respect of which OCS participated in their development. Should the project fail, EFL will not be obligated to pay any royalties.

Royalties paid or accrued for the years ended December 31, 2004, 2003 and 2002, to the OCS amounted to $17,406, $435 and $32,801, respectively.

As of December 31, 2004, the total contingent liability to the OCS was approximately $10,158,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

2. EFL, in cooperation with a U.S. participant, has received approval from the Israel-U.S. Bi-national Industrial Research and Development Foundation ("BIRD-F") for 50% funding of a project for the development of a hybrid propulsion system for transit buses. The maximum approved cost of the project is approximately $1.8 million, and the EFL's share in the project costs is anticipated to amount to approximately $1.1 million, which will be reimbursed by BIRD-F at the aforementioned rate of 50%. Royalties at rates of 2.5%-5% of sales are payable up to a maximum of 150% of the grant received, linked to the U.S. Consumer Price Index. Accelerated royalties are due under certain circumstances.

EFL is obligated to pay royalties only on sales of products in respect of which BIRD-F participated in their development. Should the project fail, EFL will not be obligated to pay any royalties.

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2004.

As of December 31, 2004, the total contingent liability to pay BIRD-F (150%) was approximately $772,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

b. Lease commitments:

The Company and its subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2009. The minimum rental payments under non-cancelable operating leases are as follows:

	Year ended December 31
2005	$ 762,636
2006	$ 305,109
2007	$ 269,220
2008	$ 66,688
2009	$ 24,312

Total rent expenses for the years ended December 31, 2004, 2003 and 2002 were approximately $868,900, $484,361 and $629,101, respectively.

c. Guarantees:

The Company obtained bank guarantees in the amount of $1,199,096 in connection with (i) the purchase agreement of one of the Company's subsidiaries (ii) obligations of two of the Company's subsidiaries to the Israeli customs authorities and (iii) obligation of one of the Company's subsidiaries to secure inventory received from one of its customers. In addition, the Company issued letters of credit in amounts of $143,895 and $2,000,000 to one of its subsidiary's suppliers and to one of its subsidiary's customers respectively.

d. Liens:

As security for compliance with the terms related to the investment grants from the state of Israel, EFL and Epsilor have registered floating liens on all of its assets, in favor of the State of Israel.

The Company has granted to the holders of its 8% secured convertible debentures a first position security interest in (i) the shares of MDT Armor Corporation, (ii) the assets of its IES Interactive Training, Inc. subsidiary, (iii) the shares of all of its subsidiaries, and (iv) any shares that the Company acquires in future Acquisitions (as defined in the securities purchase agreement).

EFL has granted to its former CEO a security interest in certain of its property located in Beit Shemesh, Israel, to secure sums due to him pursuant to the terms of the settlement agreement with him.

FAAC has a $3 million line of credit secured by all of its accounts receivable, unbilled revenues and inventory.

Epsilor has recorded a lien on all of its assets in favor of its banks to secure lines of credit and loans received. In addition the company has a specific pledge on assets in respect of which government guaranteed loan were given.

See also Note 9 regarding automobiles purchased in EFL and Epsilor.

e. Litigation and other claims:

As of December 31, 2004, there were no pending legal proceedings to which the Company was a party, other than ordinary routine litigation incidental to its business, except as follows:

a. In December 2004, AoA filed an action against a U.S. government defense agency, seeking approximately $2.2 million in damages for alleged improper termination of a contract. In its answer, the government agency counterclaimed, seeking approximately $2.1 million in reprocurement expenses. AoA is preparing its answer to the counterclaim. At this stage in the proceedings, the Company and its legal advisors cannot determine with any certainty whether AoA will have any liability and, if so, the extent of that liability.

b. In the beginning of 2005 a competitor of FAAC brought an action against FAAC and a municipal transport agency, alleging, *inter alia*, that the municipal transport agency and FAAC have conspired to violate federal and state antitrust laws and have engaged in unfair competition with respect to this competitor. The competitor seeks unspecified monetary damages from FAAC and the municipal transport agency and injunctive relief. FAAC has not yet filed its answer in this case. At this stage in the proceedings, the Company and its legal advisors cannot determine with any certainty whether FAAC will have any liability and, if so, the extent of that liability.

c. There is an action against EFL brought in the matter of the bankruptcy of an intellectual property law firm, seeking payment of approximately $150,000, plus interest, fees and costs, in respect of unpaid legal fees and expenses. EFL has not yet filed its answer in this case. The Company and its legal advisors does not believe EFL's liability in this matter will exceed $100,000.The Company has recorded an appropriate provision in respect of this amount.

d. In 2000 and 2001, the Company sold consumer cellphone batteries and chargers to a major department store chain. Subsequent to these sales, in late 2001, one of the Company's employees signed an agreement with the department store chain to price-protect the goods previously sold, with such price protection "to be debited from current open invoices." The department store chain has recently claimed to the Company that the Company owes them approximately $517,000, primarily in respect of this price protection. The Company contends that employee who signed the price protection had no authority, actual or apparent, to do so, and that in any event the clear meaning of the language in the price protection is that the department store chain may deduct the price protection from sums they owe the Company, not that the Company is obligated to return sums previously paid. Settlement discussions are currently taking place. At this early stage, the Company and its legal advisors cannot determine with any cer-

tainty whether it will have any liability and, if so, the extent of that liability.

NOTE 13:- CONVERTIBLE DEBENTURES

a. 9% Secured Convertible Debentures due June 30, 2005

Pursuant to the terms of a Securities Purchase Agreement dated December 31, 2002, the Company issued and sold to a group of institutional investors an aggregate principal amount of 9% secured convertible debentures in the amount of $3.5 million due June 30, 2005. These debentures are convertible at any time prior to June 30, 2005 at a conversion price of $0.75 per share, or a maximum aggregate of 4,666,667 shares of common stock. The conversion price of these debentures was adjusted to $0.64 per share in April 2003. In accordance with EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," the terms of convertible debentures were not treated as changed or modified when the cash flow effect on a present value basis was less than 10%.

As part of the securities purchase agreement on December 31, 2002, the Company issued to the purchasers of its 9% secured convertible debentures due June 30, 2005, warrants, as follows: (i) Series A Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.84 per share; (ii) Series B Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.89 per share; and (iii) Series C Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.93 per share. The exercise price of these warrants was adjusted to $0.64 per share in April 2003.

This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" ("APB No. 14") and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 64%, dividend yields of 0% and a contractual life of five years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of $1,890,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date – June 30, 2005 – or to the actual conversion date, if earlier, as financial expenses.

During 2003, an aggregate principal amount of $2,350,000 in 9% secured convertible debentures was converted into an aggregate of 3,671,875 shares of common stock and an aggregate of 1,500,042 shares were issued pursuant to exercises of the warrants.

During 2004, the remaining principal amount of $1,150,000 of 9% secured convertible debentures outstanding was converted into an aggregate of 1,796,875 shares of common stock.

During 2003 and 2004, the Company recorded expenses of $1,517,400 and $372,600, respectively, of which $548,100 and $0, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and $969,300 and $372,600, respectively, was attributable to amortization due to conversion of the convertible debenture into shares.

b. 8% Secured Convertible Debentures due September 30, 2006 and issued in September 2003

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of $5.0 million due September 30, 2006. These debentures are convertible at any time prior to September 30, 2006 at a conversion price of $1.15 per share, or a maximum aggregate of 4,347,826 shares of common stock.

As part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 1,250,000 shares of common stock at any time prior to September 30, 2006 at a price of $1.4375 per share.

This transaction was accounted according to APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments." The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of

1.95%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of $2,963,043 with respect to the beneficial conversion feature and the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date – September 30, 2006 – or to the actual conversion date, if earlier, as financial expenses.

During 2003, an aggregate principal amount of $3,775,000 in 8% secured convertible debentures was converted into an aggregate of 3,282,608 shares of common stock and an aggregate of 437,500 shares were issued pursuant to exercises of the warrants.

During 2004, an aggregate of principal amount $1,075,000 in 8% secured convertible debentures was converted into an aggregate of 934,784 shares. As of December 31, 2004, principal amount of $150,000 remained outstanding under these debentures.

During 2003 and 2004, the Company recorded expenses of $2,298,034 and $613,263, respectively, of which $205,858 and $191,895, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and $2,092,176 and $421,368, respectively, was attributable to amortization due to conversion of the convertible debenture into shares.

c. 8% Secured Convertible Debentures due September 30, 2006 and issued in December 2003

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of $6.0 million due September 30, 2006. These debentures are convertible at any time prior to September 30, 2006 at a conversion price of $1.45 per share, or a maximum aggregate of 4,137,931 shares of common stock.

As a further part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 1,500,000 shares of common stock at any time prior to December 18, 2006 at a price of $1.8125 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 1,038,000 shares of common stock at any time prior to December 31, 2006 at a price of $2.20 per share.

This transaction was accounted according to APB No. 14 “Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants” and Emerging Issue Task Force No. 00-27 “Application of Issue No. 98-5 to Certain Convertible Instruments.” The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.45%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of $6,000,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date – September 30, 2006 – or to the actual conversion date, if earlier, as financial expenses.

During 2003 the Company recorded an expense of $132,803, which represents the amortization of the beneficial conversion feature of the convertible debenture over its term.

During 2004 an aggregate of 1,500,000 shares were issued pursuant to exercise of these warrants. Out of these warrants, the holders of 1,125,000 warrants exercised their warrants on July 14, 2004 were granted an additional warrants to purchase 1,125,000 shares of common stock of the Company at an exercise price per share of $1.38. See also Note 14.f.4.

During 2004 the Company recorded expenses of $3,156,246 of which $1,782,561 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and $1,373,685 was attributable to amortization due to conversion of the convertible debenture into shares.

d. The Company’s debt agreements contain customary affirmative and negative operations covenants that limit the discretion of its management with respect to certain business matters and place restrictions on it, including obligations on the Company’s part to preserve and maintain assets and restrictions on its ability to incur or guarantee debt, to merge with or sell its assets to another company, and to make significant capital expenditures without the consent of

the debenture holders, as well as granting to the Company's investors a right of first refusal on any future financings, except for underwritten public offerings in excess of $30 million. Management does not believe that this right of first refusal will materially limit the Company's ability to undertake future financings.

NOTE 14:– SHAREHOLDERS' EQUITY

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. Issuance of common stock to investors:

1. On January 18, 2002, the Company issued a total of 441,176 shares of its common stock at a purchase price of $1.70 per share, or a total purchase price of $750,000, to an investor (see also Note 14.f.2.).

2. On January 24, 2002, the Company issued a total of 1,600,000 shares of its common stock at a purchase price of $1.55 per share, or a total purchase price of $2,480,000, to a group of investors.

3. In September 2003, the company acquired an additional 12% interest in MDT Armor Corporation and an additional 24.5% interest in MDT Protective Industries, Ltd. in exchange for the issuance to AGA Means of Protection and Commerce, Ltd. of 126,000 shares of its common stock.

4. In January 2004, the Company issued an aggregate of 9,840,426 shares of common stock at a price of $1.88 per share, or a total purchase price of $18,500,000, to a group of investors (see also Note 14.f.3.). Finance expenses in connection with this issuance totaled $692,500.

5. In July 2004, pursuant to a Securities Purchase Agreement dated July 15, 2004, the Company issued an aggregate of 4,258,065 shares of common stock at a price of $1.55 per share, or a total purchase price of $6,600,000, to a group of investors (see also Note 14.f.4.).

c. Issuance of common stock to service providers and employees, in settlement of litigation, and as donations to charities:

1. On February 15, 2002 and September 10, 2002, the Company issued 318,468 and 50,000 shares, respectively, of common stock at par consideration to a consultant for providing business development and marketing services in the United Kingdom. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided which amounted to $394,698 and $63,000, respectively, in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $394,698 and $63,000, respectively, during the year 2002 and included this amount in marketing expenses.

2. On September 10, 2002, the Company issued an aggregate of 13,000 shares of common stock at par consideration to two of its employees as stock bonuses. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by their market price at the issuance date in accordance with APB No. 25. In accordance with APB No. 25, the Company recorded this compensation expense of $13,000 during the year 2002 and included this amount in general and administrative expenses.

3. In July 2003, the Company issued 215,294 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by the market price at the issuance date and by the value of the services provided and amounted to $154,331 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $154,331 during the year 2003 and included this amount in marketing expenses.

4. In November 2003, the Company issued 8,306 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to $7,616 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $7,616 during the year 2003 and included this amount in marketing expenses.

5. In February 2004, the Company issued 74,215 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued

as reflected by their market price at the issuance date and by the value of the services provided and amounted to $171,680 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company accrued this compensation expense of $171,680 during the year 2003 and included this amount in selling and marketing expenses.

6. Beginning in January 2004, the Company entered into a consulting agreement with one of its directors pursuant to which the director agreed to aid the Company in identifying potential acquisition candidates, in exchange for a commission. The Company also agreed to issue to this director, at par value, a total of 32,000 shares of its common stock, the value of which was to be deducted from any transaction fees paid. 16,000 of these shares were earned and issued prior to termination of this agreement in August 2004. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to $28,160 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of $28,160 during the year 2004 and included this amount in general and administrative expenses

7. In June 2004 the Company sold 40,000 shares of the Company's common stock at a price of $1.00 per share to one of its employees. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by their market price at the issuance date in accordance with APB No. 25. In accordance with APB No. 25, the Company recorded this compensation expense of $53,200 during the year 2004 and included this amount in general and administrative expenses

8. In December 2004, the Company donated 40,000 shares of its common stock to a charitable organization recognized by the Internal Revenue Service as tax-exempt under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to $69,200 in accordance with EITF 96-18. This compensation expense will be amortized over the course of one year due to legal restrictions on selling these shares for that period of time. In accordance with EITF 96-18, the Company recorded compensation expense of $4,361 during the year 2004 and included this amount in general and administrative expenses

9. See Note 14.f.6.

d. Issuance of shares to lenders

As part of the securities purchase agreement on December 31, 2002 (see Note 13.a.), the Company issued 387,301 shares at par as consideration to lenders for the first nine months of interest expenses. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the interest and amounted to $236,250 in accordance with APB 14. During 2003 the Company recorded this amount as financial expenses.

e. Issuance of promissory note:

As part of its purchase of the assets of IES Interactive Training, Inc., the Company issued a $450,000 convertible promissory note (see Note 10). This note was converted into an aggregate of 563,971 shares of common stock in August 2003.

f. Warrants:

1. As part of an investment agreement in May 2001, the Company issued to the investors a total of 2,696,971 warrants (the "May 2001 Warrants") to purchase shares of common stock at a price of $3.22 per share; these warrants are exercisable by the holder at any time after November 8, 2001 and will expire on May 8, 2006.

In June and July 2003, the Company adjusted the purchase price of 1,357,577 of the May 2001 Warrants to $0.82 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 905,052 shares of common stock at a purchase price of $1.45 per share (the "June 2003 Warrants"). The June 2003 Warrants were originally exercisable at any time from and after December 31, 2003 to June 30, 2008; however, in September 2003, the exercise period of 638,385 of these June 2003 Warrants was adjusted to make them exercisable at any time from and after December 31, 2004 to June 30, 2009. As a result the company recorded during 2003 a deemed dividend in the amount of $267,026. See also Note 1.b.

In addition, with respect to an additional 387,879 May 2001 Warrants, in December 2003 the

Company adjusted the purchase price to $1.60 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 193,940 shares of common stock at a purchase price of $2.25 per share. As a result the company recorded during 2003 a deemed dividend in the amount of $82,974. See also Note 1.b.

Additionally, in October 2003 the Company granted to three of these investors additional new warrants to purchase a total of 150,000 shares of common stock at a purchase price of $1.20 per share. As a result the company recorded during 2003 an expense of $199,500 and included this amount in general and administrative expenses. During 2004, 64,557 warrants were exercised.

On July 14, 2004, the Company repriced the exercise price of 242,424 warrants granted previously in May 2001 to $1.88 in order to induce their holders to exercise them immediately. In connection with the exercise of the warrants, the Company additionally granted five-year warrants to purchase up to an aggregate of 145,454 shares of the Company's common stock at an exercise price per share of $1.38. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years. For accounting treatment, please see also Notes 14.b.4. and 14.f.4.

2. As part of the investment agreement in January 2002 (see Note 14.b.1), the Company, in January 2002, issued to a financial consultant that provided investment banking services concurrently with this transaction a warrants to acquire (i) 150,000 shares of common stock at an exercise price of $1.68 per share, and (ii) 119,000 shares of common stock at an exercise price of $2.25 per share; these warrants are exercisable by the holder at any time and will expire on January 4, 2007.

3. In connection with the Securities Purchase Agreement referred to in Note 14.b.4 above, the Company granted three-year warrants to purchase up to an aggregate of 9,840,426 shares of the Company's common stock at any time beginning six months after closing at an exercise price per share of $1.88.

In July 2004 an aggregate of 7,446,811 shares were issued pursuant to exercise of these warrants. In connection with the exercise of the warrants, the Company granted to the same investors five-year warrants to purchase up to an aggregate of 7,446,811 shares of the Company's common stock at an exercise price per share of $1.38. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years. See also Note 14.f.4.

4. On July 14, 2004, warrants to purchase 8,814,235 shares of common stock, having an aggregate exercise price of $16,494,194, net of issuance expenses, were exercised (see also Notes 14.f.1., 14.f.3. and 13.c.). Out of the shares issued in conjunction with the exercise of these warrants, 1,125,000 shares were issued upon exercise of warrants issued in the transaction referred to in Note 13.c above and 7,446,811 shares were issued upon exercise of warrants issued in the transaction referred to in the Note 14.f.4. above; the remaining 242,424 shares were issued upon exercise of a warrant that the Company issued to an investor in May 2001 referred to in Note 14.f.1 above. In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 8,717,265 new five-year warrants to purchase shares of common stock at an exercise price of $1.38 per share

As a result of the transactions described in Notes 14 f.1, 14.f.3 and 13.c., including the repricing of the warrants to the investors and the issuance of additional warrants to the investors, the Company recorded a deemed dividend in the amount of $2,165,952, to reflect the additional benefit created for these investors. The deemed dividend increased the loss applicable to common stockholders in the calculation of basic and diluted net loss per share for the year ended December 31, 2004, without any effect on total shareholder's equity.

As all warrants in the July 14, 2004, securities purchase agreement were subject to shareholders approval, in accordance with Emerging Issues Task Force No.00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. Upon obtaining stockholders approval on December 14, 2004, the warrants were remeasured and reclassified

to equity. The fair value of these warrants was determined using the Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of approximately five years. The change in the fair value of the warrants between the date of grant and December 14, 2004 has been recorded as finance income in the amount of $326,839.

5. In November 2000 and May 2001, the Company issued a total of 916,667 warrants to an investor, which warrants contained certain antidilution provisions: a Series A warrant to purchase 666,667 shares of the Company's common stock at a price of $3.50 per share, and a Series C warrant to purchase 250,000 shares at a price of $3.08 per share. Operation of the antidilution provisions provided that the Series A warrant should be adjusted to be a warrant to purchase 888,764 shares at a price of $2.67 per share, and the Series C warrant should be adjusted to be a warrant to purchase 333,286 shares at a price of $2.35 per share. After negotiations, the investor agreed in March 2004 to exercise its warrants immediately, in exchange for an exercise price reduction to $1.45 per share, and the issuance of a new six-month Series D warrant to purchase 1,222,050 shares at an exercise price of $2.10 per share. The new Series D warrant does not have similar antidilution provisions. As a result of this repricing and the issuance of new warrants, the Company recorded a deemed dividend in the amount of approximately $1,163,000 in 2004.

6. On February 4, 2004, the Company entered into an agreement settling the litigation brought against it in the Tel-Aviv, Israel district court by I.E.S. Electronics Industries, Ltd. ("IES Electronics") and certain of its affiliates in connection with the Company's purchase of the assets of its IES Interactive Training, Inc. subsidiary from IES Electronics in August 2002. The litigation had sought monetary damages in the amount of approximately $3 million. Pursuant to the terms of the settlement agreement, in addition to agreeing to dismiss their lawsuit with prejudice, IES Electronics agreed (i) to cancel the Company's $450,000 debt to them that had been due on December 31, 2003, and (ii) to transfer to the Company title to certain certificates of deposit in the approximate principal amount of $112,000. The parties also agreed to exchange mutual releases. In consideration of the foregoing, the Company issued to IES Electronics (i) 450,000 shares of common stock, and (ii) five-year warrants to purchase up to an additional 450,000 shares of common stock at a purchase price of $1.91 per share. The fair value of the warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of five years. The fair value of warrants was calculated as $483,828 and fair value of shares as $765,000.

In respect of the above settlement, the Company recorded in 2003 an expense of $688,642, representing the fair value of the warrants and shares over the remaining balance of the Company's debt to IES Electronics as carried in the Company books at December 31, 2003, less the $112,000 certificate of deposit that was transferred to the Company's name as noted above. During the year 2004, 200,000 warrants were exercised.

7. As of December 31, 2004, the Company outstanding warrants totaled 16,961,463.

g. Stock option and restricted stock purchase plans:

1. Options and restricted shares to employees and others (except consultants)

a. The Company has adopted the following stock option plans, whereby options and restricted shares may be granted for purchase of shares of the Company's common stock. Under the terms of the employee plans, the Board of Directors or the designated committee grants options and determines the vesting period and the exercise terms.

1) 1998 Employee Option Plan – as amended, 4,750,000 shares reserved for issuance, of which no shares were available for future grants to employees and consultants as of December 31, 2004.

2) 1995 Non-Employee Director Plan – 1,000,000 shares reserved for issuance, of which 355,000 were available for future grants to directors as of December 31, 2004.

3) 2004 Employee Option Plan – 7,500,000 shares reserved for issuance, of which 5,168,400 were available for future grants to employees and consultants as of December 31, 2004.

b. Under these plans, options generally expire no later than 5-10 years from the date of grant. Each option can be exercised to purchase one share, conferring the same rights as the other

common shares. Options that are cancelled or forfeited before expiration become available for future grants. The options generally vest over a three-year period (33.3% per annum) and restricted shares vest after two years; in the event that employment is terminated for cause within that period, restricted shares revert back to the Company.

c. A summary of the status of the Company's plans and other share options (except for options granted to consultants) granted as of December 31, 2003, 2002 and 2001, and changes during the years ended on those dates, is presented below:

	2004		2003		2002	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		$		$		$
Options outstanding at beginning of year	9,018,311	$ 1.37	5,260,366	$ 2.26	4,240,228	$ 2.74
Changes during year:						
Granted (1) (2)	2,248,490	$ 1.06	5,264,260	$ 0.71	1,634,567	$ 0.87
Exercised (3)	(897,248)	$ 1.24	(689,640)	$ 0.64	(191,542)	$ 1.29
Forfeited	(514,793)	$ 3.77	(816,675)	$ 3.51	(422,887)	$ 1.92
Options outstanding at end of year	9,854,760	$ 1.19	9,018,311	$ 1.37	5,260,366	$ 2.26
Options exercisable at end of year	6,465,316	$ 1.32	5,826,539	$ 1.70	4,675,443	$ 2.26

(1) Includes 936,250, 2,035,000 and 481,435 options and restricted shares granted to related parties in 2004, 2003 and 2002, respectively.

(2) The Company recorded deferred stock compensation for options and restricted shares issued with an exercise price below the fair value of the common stock in the amount of $2,081,457, $4,750 and $0 as of December 31, 2004, 2003 and 2002, respectively. Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2004, 2003 and 2002, was $831,626, $8,286 and $6,000, respectively.

(3) In June 2002, the employees exercised 100,000 options for which the exercise price was not paid at the exercise date. The Company recorded the owed amount of $73,000 as "Note receivable from stockholders" in the Statement of Changes in Stockholders' Equity. In accordance with EITF 95-16, since the original option grant did not permit the exercise of the options through loans, and due to the Company's history of granting non-recourse loans, this postponement in payments of the exercise price resulted in a variable plan accounting. However, the Company did not record any compensation due to the decrease in the market value of the Company's shares during 2002. During 2002 the note in the amount of $36,500 was forgiven and appropriate compensation was recorded. During 2003 and 2004, the Company recorded compensation expenses and (income) in amounts of $38,500 and ($10,000), respectively, due to increase and decrease in the market value of the Company's shares.

d. The options and restricted shares outstanding as of December 31, 2004 have been separated into ranges of exercise price, as follows:

	Total options outstanding			Exercisable options outstanding	
Range of exercise prices	Amount outstanding at December 31, 2004	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2004	Weighted average exercise price
$		Years	$		$
0.01-2.00	8,944,827	6.44	0.87	5,730,382	0.88
2.01-4.00	270,933	3.79	2.46	95,934	2.56
4.01-6.00	594,000	1.97	4.80	594,000	4.80
6.01-8.00	35,000	1.05	7.73	35,000	7.73
8.01	10,000	2.75	9.06	10,000	9.06
	9,854,760	6.07	1.19	6,465,316	1.32

Weighted-average fair values and exercise prices of options and restricted shares on dates of grant are as follows:

	Equals market price			Less than market price		
	Year ended December 31,			Year ended December 31,		
	2004	2003	2002	2004	2003	2002
Weighted average exercise prices	$1.494	$ 0.950	$ 1.265	$1.672	$ –	$ 0.755
Weighted average fair value on grant date	$1.002	$ 0.730	$ 0.560	$1.729	$ –	$ 0.250

2. Options issued to consultants:

a. The Company's outstanding options to consultants as of December 31, 2004, are as follows:

	2004		2003		2002	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		$		$		$
Options outstanding at beginning of year	313,901	$ 4.59	245,786	$ 5.55	245,786	$ 5.55
Changes during year:						
Granted	10,000	$ –	83,115	$ 0.99	–	$ –
Exercised	(37,615)	$ 1.03	(15,000)	$ 0.49	–	$ –
Forfeited or cancelled	(120,000)	$ 6.40	–	$ –	–	$ –
Options outstanding at end of year	166,286	$ 3.80	313,901	$ 4.59	245,786	$ 5.55
Options exercisable at end of year	166,286	$ 3.80	193,901	$ 3.46	125,786	$ 6.42

b) The Company accounted for its options to consultants under the fair value method of SFAS No. 123 and EITF 96-18. The fair value for these options was estimated using a Black-Scholes option-pricing model with the following weighted-average assumptions:

	2004	2003	2002
Dividend yield	0%	0%	–
Expected volatility	81%	78%	–
Risk-free interest	3.4%	2.3%	–
Expected life of up to	5 years	10 years	–

c. In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling $0, $29,759 and $0 for the years ended December 31, 2004, 2003 and 2002, respectively, and included these amounts in marketing and general and administrative expenses.

3. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in U.S. dollars. The Company does not intend to pay cash dividends in the foreseeable future.

4. Treasury Stock:

Treasury stock is the Company's common stock that has been issued and subsequently reacquired. The acquisition of common stock is accounted for under the cost method, and presented as reduction of stockholders' equity.

NOTE 15:– INCOME TAXES

a. Taxation of U.S. parent company (Arotech) and other U.S. subsidiaries:

As of December 31, 2004, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately $23 million, which are available to offset future taxable income, if any, expiring in 2009 through 2024. Utilization of U.S net operating losses may be 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 loses before utilization.

The Company files consolidated tax returns with its US subsidiaries.

b. Israeli subsidiary (Epsilor):

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

Currently, Epsilor is operating under three programs as follows:

1. Program one:

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law and was entitled to investments grants from the state of Israel in the amount of 24% on property and equipment located at its Dimona plant.

The approved expansion program was in the amount of approximately $350,000. Epsilor effectively operated the program during 1999 and is entitled to the tax benefits available under the Investments Law.

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier. Hence, this approved program will expire in 2005.

2. Program two:

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law and was entitled to investments grants from the State of Israel in the amount of 24% on property and equipment located at its Dimona plant.

The approved expansion program is in the amount of approximately $600,000. Epsilor effectively operated the program during 2002, and is entitled to the tax benefits available under the Investments Law (commencing from 2003).

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier. Hence, this approved program will expire in 2009.

3. Program three:

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law, and is entitled to investments grants from the State of Israel in the amount of 32% on property and equipment located at its Dimona plant.

The approved expansion program is in the amount of approximately $945,000. This program has not yet received final approval.

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier.

The main tax benefits available to Epsilor are:

a) Reduced tax rates:

As stated above for each specific program

b) Accelerated depreciation:

Epsilor is entitled to claim accelerated depreciation in respect of machinery and equipment used by the "Approved Enterprise" for the first five years of operation of these assets.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 35%.

If retained tax-exempt profits attributable to the "approved enterprise" are distributed, they would be taxed at the corporate tax rate applicable to such profits as if Epsilor had not elected the alternative system of benefits, currently 25% for an "approved enterprise."

Dividends paid from the profits of an approved enterprise are subject to tax at the rate of 15% in the hands of their recipient.

As of December 31, 2004 approximately $370,000 were derived from tax exempt profits

earned by Epsilor's "approved enterprises"; by Israeli law, the Company can distribute only $197,000 of this amount. The Company has determined that such tax exempt income in the amount of $180,000 will not be distributed as dividends.

Tax liability on what can be distributed as dividends from these tax exempt profits and other Epsilor profits in 2004 in the hand of the recipient and on the company level as stated in previous section is $51,000 and accordingly deferred tax liability was recorded as of December 31, 2004.

c. Israeli subsidiary (EFL):

1. Tax benefits under the Investments Law:

A small part of EFL's manufacturing facility has been granted "Approved Enterprise" status under the Investments Law, and was entitled to investment grants from the State of Israel of 38% on property and equipment located in Jerusalem, and 10% on property and equipment located in its plant in Beit Shemesh, and to reduced tax rates on income arising from the "Approved Enterprise," as detailed below.

The period of tax benefits granted by "Approved enterprise" is subject to limits of 12 years from the commencement of production, or 14 years from the approval date, whichever is earlier. The approved program expired in 2004. The benefits were not utilized since the Company had no taxable income, since its incorporation.

d. Other tax information about the Israeli subsidiaries:

1. Measurement of results for tax purposes under the Income Tax Law (Inflationary Adjustments), 1985

Results for tax purposes are measured in real terms of earnings in NIS after certain adjustments for increases in the Consumer Price Index. As explained in Note 2.b., the financial statements are presented in U.S. dollars. The difference between the annual change in the Israeli consumer price index and in the NIS/dollar exchange rate causes a difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of SFAS No. 109, EFL, Epsilor and MDT have not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

2. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

EFL and Epsilor are "industrial companies," as defined by this law and, as such, are entitled to certain tax benefits, mainly accelerated depreciation, as prescribed by regulations published under the inflationary adjustments law, the right to claim amortization of know-how, patents and certain other intangible property rights as deductions for tax purposes.

3. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 35%. See also Note 15.e

4. Tax loss carryforwards:

As of December 31, 2004, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately $87.0 million, which are available, indefinitely, to offset future taxable income.

e. Reduction in corporate tax rate

In June 2004, the Israeli Parliament approved an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision) (the "Amendment"), which progressively reduces the corporate tax rate from 36% to 35% in 2004 and to a rate of 30% in 2007. The amendment was signed and published in July 2004 and is, therefore, considered enacted in July 2004. As the Company currently has no taxable income, and no deferred taxes were recorded, the amendment does not have an impact on the Company's results of operation or financial position.

f. Deferred income taxes:

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

	December 31,	
	2004	2003
Operating loss carryforward	$ 32,532,998	$ 33,958,434
Reserve and allowance	1,328,479	843,453
Net deferred tax asset before valuation allowance	33,861,477	34,801,887
Valuation allowance	(33,725,995)	(34,801,887)
Total deferred tax asset	$ 135,482	$ –
Deferred tax liability	$ 51,366	$ –

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax assets related to the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2004 was $1,075,892

g. Loss from continuing operations before taxes on income and minorities interests in loss (earnings) of a subsidiary:

	Year ended December 31		
	2004	2003*	2002**
Domestic	$ 8,006,205	$ 7,411,121	$ 5,250,633
Foreign	405,305	1,697,617	13,253,725
	$ 8,411,510	$ 9,108,738	$ 18,504,358

* Restated (see Note 1.b.).
** Includes loss from discontinued operations and minority interest in loss (earnings) of a subsidiary

h. Taxes on income were comprised of the following:

	Year ended December 31		
	2004	2003	2002
Current state and local taxes	$ 539,674	$ 44,102	$ –
Deferred taxes	(37,857)	–	–
Taxes in respect of prior years	84,292	352,091	–
	$ 586,109	$ 396,193	$ –
Domestic	$ 163,087	$ 33,020	$ –
Foreign	423,022	363,173	–
	$ 586,109	$ 396,193	$ –

i. The cumulative amount of undistributed earnings of foreign subsidiaries, which is intended to be permanently reinvested and for which U.S. income taxes have not been provided, totaled approximately $180,000 and $0 on December 31, 2004 and 2003 respectively.

j. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the Statement of Operations is as follows:

	Year ended December 31,		
	2004	2003*	2002
Loss from continuing operations before taxes, as reported in the consolidated statements of income	$ (8,411,510)	$ (9,108,738)	$ (4,582,792)
Statutory tax rate	34%	34%	34%
Theoretical income tax on the above amount at the U.S. statutory tax rate	$ (2,859,914)	$ (3,096,971)	$ (1,558,149)
Deferred taxes on losses for which valuation allowance was provided	556,692	1,146,754	1,558,149
Non-deductible expenses	1,629,874	1,873,129	–
State taxes	168,081	33,020	–
Accrual for deferred taxes on undistributed earnings	49,416	–	–
Foreign income in tax rates other then U.S rate	919,895	86,954	–
Taxes in respect of prior years	84,292	352,091	–
Others	37,773	1,216	–
Actual tax expense	$ 586,109	$ 396,193	$ –

* Restated (see Note 1.b.).

NOTE 16:– SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expenses), net:

	Year ended December 31,		
	2004	2003*	2002
Financial expenses:			
Interest, bank charges and fees	$ (622,638)	$ (355,111)	$ (89,271)
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature	(4,142,109)	(3,928,237)	–
Bonds premium amortization	(202,467)	–	–
Foreign currency translation differences	(71,891)	115,538	15,202
	(5,039,105)	(4,167,810)	(74,069)
Financial income:			
Interest	443,182	129,101	174,520
Realized gain from marketable securities sale	40,119	–	–
Financial income in connection with warrants granted (note 14.f.4)	326,839	–	–
Total	$ (4,228,965)	$ (4,038,709)	$ 100,451

* Restated (see Note 1.b.).

NOTE 17:– RELATED PARTY DISCLOSURES

	Year ended December 31,		
	2004	2003	2002
Transactions:			
Reimbursement of general and administrative expenses	$ –	$ –	$ 36,000
Financial income (expenses), net from notes receivable and loan holders	$ 18,251	$ –	$ (7,309)

NOTE 18:– SEGMENT INFORMATION

a. General:

The Company and its subsidiaries operate primarily in three business segments (see Note 1.a. for a brief description of the Company's business) and follow the requirements of SFAS No. 131.

Prior to its purchase of FAAC, Epsilor and AoA, the Company had managed its business in two reportable segments organized on the basis of differences in its related products and services. With the acquisition of FAAC and Epsilor early in 2004 and AoA in August of 2004, the Company reorganized into three segments: Simulation and Security; Armor; and Battery and Power Systems. As a result the Company restated information previously reported in order to comply with new segment reporting.

The Company's reportable operating 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 operating segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based upon two primary factors, one is the segment's operating income and the other is based on the segment's contribution to the Company's future strategic growth.

b. The following is information about reported segment gains, losses and assets:

	Simulation and Security	Armor	Battery and Power Systems	All Others(4)	Total
2004					
Revenues from outside customers	$21,464,406	$17,988,687	$10,500,753	$ –	$49,953,846
Depreciation expenses and amortization [1]	(1,983,822)	(1,755,847)	(1,132,953)	(135,613)	(5,008,235)
Direct expenses [2]	(17,910,967)	(16,444,476)	(9,974,544)	(5,431,627)	(49,761,614)
Segment net income (loss)	$ 1,569,617	$ (211,636)	$ (606,744)	$ (5,567,240)	(4,816,003)
Financial expenses (after deduction of minority interest)					(4,226,310)
Net loss from continuing operations					$(9,042,313)
Segment assets [3]	$ 1,872,943	$ 5,819,266	$ 3,455,188	$ 730,595	$11,877,992
2003*					
Revenues from outside customers	$ 8,022,026	$ 3,435,716	$ 5,868,899	$ –	$17,326,641
Depreciation expenses and amortization	(757,997)	(169,668)	(527,775)	(139,630)	(1,595,070)
Direct expenses [2]	(7,308,649)	(3,584,284)	(5,945,948)	(4,200,770)	(21,039,651)
Segment net income (loss)	$ (44,620)	$ (318,236)	$ (604,824)	$ (4,340,400)	(5,308,080)
Financial expenses (after deduction of minority interest)					(4,039,951)
Net loss from continuing operations					$(9,348,031)
Segment assets [3]	$ 898,271	$ 730,291	$ 2,128,062	$ 450,864	$ 4,207,488
2002					
Revenues from outside customers	$ 1,980,061	$ 2,744,382	$ 1,682,296	$ –	$ 6,406,739
Depreciation expenses and amortization [1]	(569,832)	(106,921)	(252,514)	(194,014)	(1,123,281)
Direct expenses [1]	(2,037,775)	(2,315,995)	(3,062,548)	(2,905,743)	(10,322,061)
Segment net income (loss)	$ (627,546)	$ 321,466	$ (1,632,766)	$ (3,099,757)	(5,038,603)
Financial income (after deduction of minority interest)					100,451
Net income from continuing operations					$(4,938,152)
Segment assets [3]	$ 655,143	$ 1,028,682	$ 2,007,291	$ 575,612	$ 4,266,728

* Restated (see Note 1.b.).
(1) Including property and equipment depreciation, intangible assets amortization and amortization of adjustment of one of the Company's subsidiaries' inventory to market values as of the purchase date.
(2) Including sales and marketing, general and administrative expenses.
(3) Including property and equipment and inventory.
(4) Including unallocated costs.

c. Summary information about geographic areas:

The following presents total revenues according to end customers location for the years ended December 31, 2004, 2003 and 2002, and long-lived assets as of December 31, 2004, 2003 and 2002:

	2004		2003		2002	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars					
U.S.A.	$40,656,729	$45,154,086	$10,099,652	$ 6,778,050	$ 2,787,250	$ 6,710,367
Germany	319,110	–	2,836,725	–	38,160	–
England	344,261	–	29,095	–	47,696	–
Thailand	–	–	95,434	–	291,200	–
India	3,061,705	–	–	–	–	–
Israel	4,212,408	13,560,822	3,576,139	2,954,441	2,799,365	3,367,320
Other	1,359,633	–	689,596	–	443,068	–
	$49,953,846	$ 58,714,908	$17,326,641	$ 9,732,491	$ 6,406,739	$10,077,687

d. Revenues from major customers:

	Year ended December 31,		
	2004	2003 %	2002
Batteries and power systems:			
Customer A	8%	27%	8%
Armor:			
Customer B	4%	17%	43%
Customer C	24%	–	–
Simulation and security:			
Customer D	13%	–	–
Customer E	1%	16%	–

e. Revenues from major products:

	Year ended December 31,		
	2004	2003	2002
Electric vehicle	$ 232,394	$ 408,161	$ 460,562
Water activated batteries	921,533	703,084	647,896
Military batteries	9,324,247	4,757,116	573,839
Car armoring	17,988,686	3,435,715	2,744,382
Simulators	21,414,968	7,961,302	1,980,060
Other	72,018	61,263	–
Total	$49,953,846	$17,326,641	$6,406,739

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SUPPLEMENTARY FINANCIAL DATA

Quarterly Financial Data (unaudited) for the two years ended December 31, 2004

2004	Quarter Ended* March 31	June 30	September 30	December 31
Net revenue	$ 7,182,254	$ 9,928,248	$ 16,272,521	$ 16,570,823
Gross profit	$ 2,625,034	$ 3,353,501	$ 4,723,573	$ 5,240,644
Net profit (loss) from continuing operations	$ (2,517,889)	$ (4,396,123)	$ 1,126,845	$ (3,255,146)
Net loss from discontinued operations	$ –	$ –	$ –	$ –
Net profit (loss) for the period	$ (2,517,889)	$ (4,396,123)	$ 1,126,845	$ (3,255,146)
Deemed dividend to certain stockholders of common stock	$ (1,163,000)	$ –	$ (2,165,952)	$ –
Net loss attributable to common stockholders	$ (3,680,889)	$ (4,396,123)	$ (1,039,107)	$ (3,255,146)
Net profit (loss) per share – basic and diluted	$ (0.06)	$ (0.07)	$ (0.01)	$ (0.04)
Shares used in per share calculation	59,406,466	64,499,090	76,744,251	79,075,181

2003*	Quarter Ended March 31	June 30	September 30	December 31
Net revenue	$ 4,033,453	$ 3,493,135	$ 5,705,898	$ 4,094,155
Gross profit	$ 1,399,734	$ 1,013,965	$ 2,453,575	$ 1,371,527
Net loss from continuing operations	$ (1,291,122)	$ (2,788,348)	$ 218,606	$ (5,487,167)
Net income (loss) from discontinued operations	$ (95,962)	$ 179,127	$ (2,285)	$ 29,529
Net income (loss) for the period	$ (1,387,083)	$ (2,609,221)	$ 216,321	$ (5,457,638)
Deemed dividend to certain stockholders of common stock	$ –	$ (172,350)	$ (94,676)	$ (82,974)
Net income (loss) attributable to common stockholders	$ (1,387,083)	$ (2,781,571)	$ 121,645	$ (5,540,612)
Net loss per share – basic and diluted	$ (0.04)	$ (0.08)	$ 0.00	$ (0.13)
Shares used in per share calculation	34,758,960	36,209,872	40,371,940	43,604,830

* Restated (see Note 1.b. of Notes to Consolidated Financial Statements).

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2004, 2003 and 2002

Description	Balance at beginning of period	Additions charged to costs and expenses	Balance at end of period
Year ended December 31, 2004			
Allowance for doubtful accounts	$ 61,282	$ (5,888)	$ 55,394
Allowance for slow moving inventory	96,350	121,322	217,672
Valuation allowance for deferred taxes	34,801,887	(1,075,892)	33,725,995
Totals	$ 34,959,519	$ (960,458)	$ 33,999,061
Year ended December 31, 2003			
Allowance for doubtful accounts	$ 40,636	$ 20,646	$ 61,282
Allowance for slow moving inventory	-	96,350	96,350
Valuation allowance for deferred taxes	29,560,322	5,241,565	34,801,887
Totals	$ 29,600,958	$ 5,358,561	$ 34,959,519
Year ended December 31, 2002			
Allowance for doubtful accounts	$ 39,153	$ 1,483	$ 40,636
Valuation allowance for deferred taxes	12,640,103	16,920,219	29,560,322
Totals	$ 12,679,256	$ 16,921,702	$ 29,600,958

AROTECH DIRECTORS

Robert S. Ehrlich, Director
Chairman, President and
Chief Executive Officer, Arotech Corporation

Edward J. Borey, Director
Chairman and Chief Executive Officer,
WatchGuard Technologies, Inc.

Dr. Jay M. Eastman, Director
President and Chief Executive Officer,
Lucid, Inc.

Steven Esses, Director
Executive Vice President and
Chief Operating Officer, Arotech Corporation

Lawrence M. Miller, Director
Senior Partner
Schwartz, Woods and Miller

Jack E. Rosenfeld, Director
Executive Chairman of the Board,
Potpourri Group, Inc.

Bert W. Wasserman, Director
Former Executive Vice President and
Chief Financial Officer of Time Warner, Inc.

AROTECH CORPORATE OFFICERS

Robert S. Ehrlich
Chairman, President and CEO

Steven Esses
Executive Vice President and COO

Arik Arad
Chairman, AoA and IES

John Nehmens
General Manager, AoA

Greg Otte
President, IES

Dr. Neal Naimer
President, Battery Division

Graydon Hansen
President, EFBC

Alan G. Jordan
Chairman, FAAC

Joseph Bar and Jonathan Whartman
General Managers, MDT

Avihai Shen
Vice President – Finance and CFO

Yaakov Har-Oz
Vice President, General Counsel and Secretary

Kim Kelly
Vice President – Corporate Communications

Danny Waldner
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Monday, July 11, 2005, at 10:00 a.m. local time in the Ballroom of the Shelburne Murray Hill Hotel, 303 Lexington Avenue, New York, New York.

Stock Transfer Agent

American Stock Transfer & Trust Company, 59 Maiden Lane, New York, New York 10038.

Shares Traded

The stock of Arotech Corporation is traded on the Nasdaq National 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, 354 Industry Drive, Auburn, Alabama 36830.

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.

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AROTECH

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