

# Arotech Corporation



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

## Annual Report 2005

Nasdaq: ARTX

**AROTECH**



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



*Simulation and Training Division*



*Armor Division*



*Battery & Power Systems Division*



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## **Annual Report 2005**

**Nasdaq: ARTX**

***AROTECH***



*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, 2006.*

**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.*

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May 2006

**Dear Fellow Shareholder,**

2005 was a challenging year for Arotech. While we continued to enjoy strong demand for our simulation and training products, we were faced with the disappointing performance of our Armor division, particularly of our Armour of America subsidiary.

As a result, during the third quarter of 2005, we initiated a restructuring program. It includes consolidating and growing our existing businesses and instituting a corporate austerity program to dramatically reduce costs as part of our goals to achieve sustainable profitable growth.

We made notable progress towards achieving these goals since initiating the program. We are consolidating our Simulation and Training operations by relocating our IES Interactive Training subsidiary from Denver to our FAAC subsidiary's headquarters in Ann Arbor, Michigan, to which we have also relocated our corporate headquarters. This move will enable us to realize product synergies which we believe will further enhance our leading position in both military driving and law-enforcement training solutions. We are also close to completing the relocation of our Armour of America operations to MDT's headquarters in Auburn, Alabama. We believe that both of these moves will enable us to achieve overhead efficiencies and reduce operating costs.

### ***Highlights of 2005***

#### **Simulation and Training Division**

Throughout 2005 we experienced strong demand for our simulation training solutions from a wide variety of customers.

We continued to supply our driving simulators under the US Army's Common Driver Training program, for which we are the primary supplier. We also supplied MTVR simulators to the US Marine Corps and more recently announced that we received orders to upgrade all of the Marines MTVR simulators with simulated armored kits. In addition, we received orders from the military for our pilot combat training simulators.

In addition, we are in the process of delivering several commercial transit simulation projects, including the highly prestigious New York Subway simulation project. We had a major breakthrough in the international market with an order for a simulation training solution for UK's First, representing London Bus. We have since established a presence in the UK and are in the process of pursuing more opportunities.

As part of our focus on the First Responder market, we were awarded a contract from the County of Los Angeles Fire Department for our Incident Command Training Solution. The new simulator provides both strategic and tactical training for firefighters facing incidents that require a well defined emergency incident command structure. We hope to expand this technology into military and law enforcement training as well.

During 2005, we delivered our new MILO interactive training presentation system to a multitude of law enforcement agencies including nine agencies in Arizona alone.



## **Armor Division**

Compared to 2004, revenues for the year declined substantially in the Armor Division due to the poor performance of our Armour of America subsidiary and to certain orders for our MDT Armor subsidiary being pushed out to later dates.

We expect to improve our performance in this division in 2006 and were recently awarded a record \$22 million in orders from the Israel Defense Force for our "David" combat armored vehicles, which we expect to begin to fill starting in the second half of 2006. The "David" is an ultra-light armored personnel carrier for combat missions designed for the urban low intensity conflict. With a small footprint (considerably shorter, lighter and narrower than the up-armored HMMWV), it is ideal for operating in urban and other densely populated areas. We believe the "David" can be appropriate to many urban warfare situations, and we are planning on presentations of the David to other militaries facing similar urban warfare situations.

During the year, we continued to receive orders for armored Toyota Land Cruisers, Land Rover Defenders and armored ambulances based on the Ford Econoline E350 van. We also received first orders for the upgraded armored Land Rover Defender 110. This upgrade increases the space inside the vehicle, greatly enhancing passenger comfort, all without sacrificing the armor package.

## **Battery and Power Systems Division**

In 2005, we received several important development contracts from a variety of customers, including NASA, for our fourth generation zinc-air technology. We recently announced the receipt of additional funding from the US Army for a third development phase for this technology.

We also started delivering our new 8150 battery for evaluation by both the Army and the Air Force.

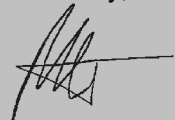
We are witnessing increasing demand for our rechargeable batteries and adaptors and have announced various orders for these batteries. We see this area of business continuing to gain momentum in 2006.

## ***Looking Ahead***

**In 2006**, we will continue to focus our efforts on the organic growth of the Company and ultimately achieving GAAP profitability through our existing operations. We expect to see the benefits of the restructuring program in the second half of the year, which is our historically strong period.. With this in place, we believe that we can grow our existing product portfolio, increase market share, and achieve our goals of sustainable profitable growth through existing operations. We are currently engaged in several important projects which we believe will enable us to show an overall growth in revenues and improve our operating results in 2006.

On behalf of the entire Company, I would like to express our gratitude to our dedicated shareholders.

Sincerely,



Robert S. Ehrlich  
Chairman and Chief Executive Officer



## General

We are a defense and security products and services company, engaged in three business areas: high-level armoring for military and nonmilitary air and ground vehicles; interactive simulation for military, law enforcement and municipal markets; and batteries and charging systems for the military. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate primarily 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 high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our ***Simulation and Training 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., currently being relocated from Littleton, Colorado to Ann Arbor, Michigan ("IES").

➤ We utilize sophisticated lightweight materials and advanced engineering processes to manufacture aviation armor and to armor vehicles through our ***Armor Division***:

- We manufacture ballistic and fragmentation armor kits for rotary and fixed wing aircraft and marine armor through our subsidiary Armour of America, currently being relocated from Los Angeles, California, to Auburn, Alabama ("AoA"); and
- We use state-of-the-art lightweight armoring materials, special ballistic glass and advanced engineering processes to fully armor military and civilian SUV's, buses and vans, 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 defense 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 batteries and battery electronics 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").

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 subsidiaries, MDT (in Israel) and MDT Armor (in the U.S.); 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 16 of the Notes to the Consolidated Financial Statements. For financial information about geographic areas in which we engage in busi-



ness, see Note 16.c of the Notes to the Consolidated Financial Statements.

### **Facilities**

Our principal executive offices have recently been relocated to 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is [www.arotech.com](http://www.arotech.com). Our periodic reports, 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 Gardena, California, and the offices and facilities of EFB and MDT Armor are located in Auburn, Alabama. In order to achieve greater efficiency and cost-savings, we began the process, early in 2006, of moving AoA's offices from Gardena, California to MTD Armor's offices in Auburn, Alabama, and IES's offices from Littleton, Colorado to FAAC's offices in Ann Arbor, Michigan.

### **Simulation and Training Division**

We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our Simulation and Training Division, the largest of our three divisions. During 2005, 2004 and 2003 revenues from our Simulation and Training Division were approximately \$26.8 million, \$21.5 million and \$8.0 million, respectively (on a pro forma basis, assuming we had owned all components of our Simulation and Training Division since January 1, 2003, revenues in 2005, 2004 and 2003

would have been approximately \$26.8 million, \$21.5 million and \$17.9 million, respectively).

### **Vehicle Driving Simulators and Incident Command Training**

We provide simulators, systems engineering and software products such as our Incident Command Training product 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 270 simulators that have successfully trained hundreds of thousands of drivers. Our customer base includes all branches of the U.S. Department of Defense, state and local governments, and municipal entities.

#### **INTRODUCTION**

We conduct our vehicle simulator business in two primary areas: Vehicle Driving 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 municipal, 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 2005, Vehicle Simulations accounted for approximately 85% of our vehicle simulation revenues, and Military Operations accounted for approximately 15% 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 driving 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 blow-out 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 vehicle operator driver training simulators since 1999 and hold

a market share in excess of 50% in U.S. municipal wheeled vehicle simulators.

#### *PRODUCT LINES*

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

##### *Vehicle Driving 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) a multi-year IDIQ task-order contract for the development of vehicle simulators and related training services for the U.S. armed services; (ii) a series of scheduled General Services Administration purchases of simulators; (iii) Congressional plus-up funding for three simulators to the National Guard in three states; and (iv) a 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 and a second award for 26 Interim Tactical Wheeled Vehicle Simulators.

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 Military Operator Driver Simulator, initially developed for the USMC and subsequently reconfigured and delivered to support the U.S. Army and U.S. Naval Construction Battalion. The MIL 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 vehicle being modeled. The high-fidelity version of the STS consists of a modified production cab unit mounted on a full six-degree-of-freedom motion platform. Other versions with industry exclusive seat-motion and generic reconfigurable cabs are available. 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;
- Driving in 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.

#### Municipal Vehicles

The Municipal 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 Municipal Vehicles business: transit, commercial, airport, and other municipal 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 many of the leading U.S. transit authorities, including the New York City Tran-

sit Authority, Washington, D.C. Metro, Los Angeles MTA, Dallas Area Rapid Transit, and the Chicago Transit Authority. Our first European bus simulator was installed in London this year, and we were competitively awarded a major rail simulator program with New York City Transit.

#### Public Safety

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.

One of our newest products is our Incident Command Training (ICT) system. Our custom ICT systems includes a comprehensive suite of simulation tools to promote both strategic and tactical training for firefighters facing incidents that require a well defined command and control structure. The ICT system, the first of which has been installed at the new Los Angeles Fire Fighter Training Academy, includes a broad range of incidents typically faced by firefighters as well as incidents involving weapons of mass destruction (WMD) and other acts of terrorism. The ICT system will provide immersive training for single agency incidents involving the fire service alone, as well as interagency incidents requiring a unified command structure including fire, police, emergency medical services, utilities, and other emergency response agencies.

#### 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 Challenger Transportation, 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 2005, we added the F-16 to the F-15, F-18 and Joint Strike Fighter (JSF) fighter to strengthen the list of aircraft fielding FAAC MLE software. 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 25% 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, the offices of which we are in the process of relocating to Ann Arbor, Michigan.

#### *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 superior to competing products 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. We produce an interactive system especially for TASER products called the TASER™ Judgmental Trainer, which delivers advance simulated training for law enforcement and government agencies deploying TASER non-lethal devices.
- *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.

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 in-

clude 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 address 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 2005, 2004 and 2003 revenues from our Armor Division were approximately \$12.3 million, \$18.0 million and \$3.4 million, respectively (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$12.3 million, \$29.2 million and \$10.9 million, respectively).

#### ***Aircraft Armoring***

##### *INTRODUCTION*

Through our subsidiary Armour of America, presently located in Gardena, California and being relocated to Auburn, Alabama, 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 ca-



pable 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; Aerospa-tiale'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, 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 9001:2000 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).

## **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 2005, 2004 and 2003 revenues from our Battery and Power Systems Division were approximately \$9.9 million, \$10.5 million and \$5.9 million, respectively (on a pro forma basis, assuming we had owned all components of our Battery and Power Systems Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$9.9 million, \$10.5 million and \$10.8 million, respectively).

### ***Lithium Batteries and Charging Systems for the Military***

#### *INTRODUCTION*

We sell lithium batteries and charging systems to the military through our subsidiary Epsilon 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 have opened a lithium battery production 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 and chargers to be sold using funding from the Foreign Military Sales (FMS) program to countries such as Israel and Turkey.

#### *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 Epsilon 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 batteries, rechargeable batteries and battery 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 ( $\text{LiSO}_2$ ) 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 275 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  $\text{LiSO}_2$  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.

#### 8140/U

The BA-8140/U is a new product that has recently been qualified and that has already generated initial sales of over 5,000 batteries from CECOM. 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 have recently qualified four more electrical interfaces. These 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<sub>2</sub> battery packs. We have also developed a hybrid system that incorporates ultracapacitors. We received our first orders for this man-portable hybrid power source from the U.S. Army late in 2005.

#### 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 500 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 and 2005, we were awarded \$1.65 million of congressional funds and CECOM funding for the first two phases 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 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.

At this time the technical activity on our Electric Vehicle program is on hold while we seek funding to introduce this technology commercially.

### *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 turn-around 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 and which ended in 2005, was a \$1.5 million cost-shared program (half of which was funded by the FTA and the remainder by the program partners, including us) that explored steps necessary for commercializing the all-electric zinc-air/ultracapacitor hybrid bus. It focused 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 lights, 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, 2005 and 2004, our backlog for the following years was approximately \$18.3 million and \$25.0 million, respectively, divided among our divisions as follows:



Division	2005	2004
Simulation and Training Division.....	\$ 9,379,000	\$ 12,691,000
Battery and Power Systems Division .....	4,523,000	8,325,000
Armor Division.....	4,440,000	4,002,000
<b>TOTAL:</b> .....	<u>\$ 18,342,000</u>	\$ 25,018,000

### Major Customers

During 2005, including all of our divisions, various branches of the United States military accounted for approximately 33% of our revenues.

### Price Range of Common Stock

Our common stock is traded on the Nasdaq National Market. Our Nasdaq ticker symbol is "ARTX." The following table sets forth, for the periods indicated, the range of high and low sales prices of our common stock on the Nasdaq National Market System:

Year Ended December 31, 2005	High	Low
Fourth Quarter.....	\$ 0.76	\$0.36
Third Quarter.....	\$ 1.19	\$0.70
Second Quarter.....	\$ 1.46	\$1.00
First Quarter.....	\$ 1.78	\$1.26

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

As of February 28, 2006 we had approximately 324 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, 2005, 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 and 2001 have been reclassified in the accompanying statements of operations as discontinued operations. Our accompanying consolidated balance sheets at December 31, 2003, 2002 and 2001 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.

The Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated.

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

	Year Ended December 31,				
	2001	2002	2003**	2004	2005
	(dollars in thousands, except per share data)				
<b>Statement of Operations Data:</b>					
Revenues.....	\$ 2,094	\$ 6,407	\$ 17,326	\$ 49,954	\$ 49,045
Research and development expenses and costs of revenues.....	2,448	5,108	12,141	35,742	35,684
Selling, general and administrative expenses and their impairment and amortization of intangible assets.....	3,934	5,982	10,255	18,394	34,662
Operating loss.....	(4,288)	(4,683)	(5,070)	(4,182)	(21,301)
Other income .....	—	—	—	—	339
Financial income (expenses), net.....	263	100	4,039	4,229	(2,706)
Loss before minority interest in (loss) earnings of subsidiary and tax expenses.....	(4,026)	(4,583)	(9,109)	(8,411)	(23,668)
Taxes on income.....	—	—	(396)	(586)	(237)
Loss from affiliated company.....	—	—	—	—	(75)
Minority interest in (loss) earnings of subsidiary.....	—	(355)	157	(45)	57
Loss from continuing operations.....	(4,026)	(4,938)	(9,348)	(9,042)	(23,923)
Income (loss) from discontinued operations.....	(13,261)	(13,566)	110	—	(120)
Net loss for the period.....	(17,287)	(18,504)	(9,238)	(9,042)	(24,043)
Deemed dividend to certain stockholders of common stock.....	(1,197)	—	(350)	(3,329)	—
Net loss attributable to stockholders of common stock ..	<u>\$ (18,483)</u>	<u>\$ (18,504)</u>	<u>\$ (9,588)</u>	<u>\$ (12,371)</u>	<u>\$ (24,043)</u>
Basic and diluted net loss per share from continuing operations .....	<u>\$ (0.21)</u>	<u>\$ (0.15)</u>	<u>\$ (0.24)</u>	<u>\$ (0.13)</u>	<u>\$ (0.29)</u>
Loss per share for combined operations.....	<u>\$ (0.76)</u>	<u>\$ (0.57)</u>	<u>\$ (0.25)</u>	<u>\$ (0.18)</u>	<u>\$ (0.29)</u>
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands).....	24,200	32,382	38,890	69,933	82,209
	As At December 31,				
	2001	2002	2003**	2004	2005
	(dollars in thousands)				
<b>Balance Sheet Data:</b>					
Cash, cash equivalents, investments in marketable debt securities and restricted collateral deposits.....	\$ 12,672	\$ 2,091	\$ 14,391	\$ 13,832	\$ 10,864
Receivables and other assets .....	11,515	7,895	8,898	25,746	29,166
Property and equipment, net of depreciation.....	2,221	2,555	2,293	4,601	4,253
Goodwill and other intangible assets, net.....	—	7,522	7,440	54,113	40,586
Total assets.....	<u>\$ 26,408</u>	<u>\$ 20,063</u>	<u>\$ 33,022</u>	<u>\$ 98,292</u>	<u>\$ 84,869</u>
Current liabilities .....	\$ 3,874	\$ 7,272	\$ 6,710	\$ 26,381	\$ 26,317
Long-term liabilities .....	3,126	3,753	4,686	6,438	12,287
Stockholders' equity .....	19,408	9,038	21,626	65,473	46,265
Total liabilities and stockholders equity .....	<u>\$ 26,408</u>	<u>\$ 20,063</u>	<u>\$ 33,022</u>	<u>\$ 98,292</u>	<u>\$ 84,869</u>

\*\*Includes assets and liabilities, as applicable, from discontinued operations.

\*\*\*Restated.

Includes minority interest.



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

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*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 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. We operate in three business units:

- we develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement, security and other personnel (our **Simulation and Training Division**);
- we manufacture aviation armor and we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our **Armoring Division**); and
- we manufacture and sell Zinc-Air and lithium 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 Training Division); Epsilon Electronic Industries, Ltd., located in Dimona, Israel, which develops and sells rechargeable and primary lithium batteries and smart charg-

ers 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 manufactures 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. Our financial results for 2004 do not include the activities of FAAC, Epsilon or AoA for the full year and therefore are not directly comparable to our financial results for 2005.

### 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 dif-



ferent 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 outcome 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 termination 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 2005, no sig-

nificant 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.

During 2005, we performed an impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows, as a response to several factors, including without limitation the reduced sales in AoA (a component of our Armor Division), the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA and us, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular – specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), and the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, the appropriation of substantial funds earmarked for defense was delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, we identified in AoA an impairment of goodwill in the amount of \$11,757,812.

In connection with our acquisition of AoA, we have a contingent earnout obligation in an amount equal to the revenues realized by us from certain specific programs that were identified by us and the former shareholder of AoA as appropriate targets for revenue increases. The earnout provides that if AoA receives certain types of orders from certain specific customers prior to December 31, 2006 ("Additional Orders"), then upon shipment of goods in connection with such Additional Orders, the former shareholder of AoA will be paid an earnout based on revenues, up to a maximum of an additional \$6 million. To date, we have accrued a liability of \$1,204,150 in respect of such earnout obligation.

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.

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. As of December 31, 2004, we identified an impairment of the technology previously purchased from Bristlecone and, as a result, we recorded an impairment loss in the amount of \$320,279. As of December 31, 2005, we identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$498,944.

### ***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***

#### ***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 Training 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 manufactures 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 cells, 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").

We are in the process of relocating the operations of IES to Ann Arbor, Michigan (adjacent to FAAC), and the operations of AoA to Auburn, Alabama (adjacent to MDT Armor).

### **Overview of Results of Operations**

We incurred significant operating losses for the years ended December 31, 2005, 2004 and 2003. 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. However, in 2005 our net loss increased to \$23.9 million on revenues of \$49.0 million. About half of this loss was the result of impairments during 2005 of goodwill and other intangible assets in connection with our AoA subsidiary; the remainder of the increase in net loss was attributable to the factors cited below.

A portion of our operating loss during 2005 and 2004 arose as a result of non-cash charges. In addition to the charges in respect of write-offs of goodwill and other intangible assets described under "Critical Accounting Policies – Goodwill," above, 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 2006, 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 2006. We are required to review intangible assets for impairment whenever events or changes in circumstances 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 in the amount of \$3.1 million during 2005. In addition, we incurred non-cash charges for impairment of goodwill and other intangible assets in the amount of \$12.3 million during 2005, primarily in respect of AoA. 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 bene-

ficial conversion feature in the amount of \$1.7 million during 2005.

#### *ISSUANCES OF RESTRICTED SHARES, OPTIONS AND WARRANTS*

During 2004 and 2005, 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.

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 \$521,000 during 2005.

As a result of options granted to employees, we incurred non-cash charges related to stock-based compensation in the amount of \$154,000 during 2005.

As a result of shares granted to consultants and shares granted as a donation, we incurred non-cash charges related to stock-based compensation in the amount of \$538,000 during 2005.

As part of our Securities Purchase Agreement dated September 29, 2005 (see Note 12.d. of the Notes to Consolidated Financial Statements), we issued warrants to purchase up to 5,250,000 shares of common stock. Because the terms of the warrants referred to above provided that upon exercise of a warrant we could issue only stock that had been registered with the SEC (which occurred in December 2005) and was therefore freely tradable, 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," the fair value of the warrants was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. The fair value of these warrants was remeasured as at December 31, 2005 using the Black-Scholes pricing model assuming a risk free interest rate of 3.87%, a volatility factor of 64%, dividend yields of 0% and a contractual life of approximately one year. The change in the fair value of the warrants between the date of the grant and December 31, 2005 in the amount of \$377,803 has been recorded as finance income.



## 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 positive EBITDA, a goal we achieved for the first time in our history in the second half of 2004, in part through the acquisition of businesses with strong revenues and profitable operations; however, we did not achieve such results in 2005.

In our Simulation and Training Division, revenues grew from approximately \$21.5 million in 2004 to \$26.8 million in 2005. We attribute this to the receipt by our FAAC subsidiary of a number of substantial orders from, for example, the United States Army. As of December 31, 2005, our funded backlog for our Simulation and Training Division totaled \$9.4 million.

Our Armor Division had disappointing revenues during 2005, with revenues falling from approximately \$18.0 million in 2004 to \$12.3 million in 2005 (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2004, revenues would have fallen from approximately \$29.2 million in 2004 to \$12.3 million in 2005). We attribute this to the unsatisfactory results of our MDT Armor subsidiary. As of December 31, 2005, our backlog for our Armor Division totaled \$9.4 million.

In our Battery and Power Systems Division, revenues fell from approximately \$10.5 million in 2004 to \$9.9 million in 2005. We attribute this to reduced equipment purchases by one of the customers of our Epsilon subsidiary. As of December 31, 2005, our backlog for our Battery and Power Systems Division totaled \$4.5 million.

## Results of Operations

### Preliminary Note

#### SUMMARY

Results of operations for the years ended December 31, 2005 and 2004 include the results of AoA for the period following our acquisition of AoA in August of 2004. AoA's results are therefore reflected in all of 2005 but only part of 2004. 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, 2005 and 2004, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2005	2004
<b>Revenues:</b>		
Simulation and Training Division .....	\$ 26,805,772	\$ 21,464,406
Armor Division .....	12,322,678	17,988,687
Battery and Power Systems Division ...	9,916,145	10,500,753
	<u>\$ 49,044,595</u>	<u>\$ 49,953,846</u>
<b>Cost of revenues:</b>		
Simulation and Training Division .....	\$ 15,835,735	\$ 11,739,690
Armor Division .....	11,206,442	15,449,084
Battery and Power Systems Division ...	7,341,559	6,822,320
	<u>\$ 34,383,736</u>	<u>\$ 34,011,094</u>
<b>Research and development expenses:</b>		
Simulation and Training Division .....	\$ 209,554	\$ 395,636
Armor Division .....	139,514	17,065
Battery and Power Systems Division ...	951,361	1,318,678
	<u>\$ 1,300,429</u>	<u>\$ 1,731,379</u>
<b>Sales and marketing expenses:</b>		
Simulation and Training Division .....	\$ 2,704,880	\$ 3,185,001
Armor Division .....	834,090	565,981
Battery and Power Systems Division ...	853,378	1,171,235
All Other .....	79,242	—
	<u>\$ 4,471,590</u>	<u>\$ 4,922,217</u>
<b>General and administrative expenses:</b>		
Simulation and Training Division .....	\$ 3,849,881	\$ 2,852,969
Armor Division .....	2,181,355	1,323,982
Battery and Power Systems Division ...	974,704	965,058
All Other .....	7,856,495	5,514,857
	<u>\$ 14,862,435</u>	<u>\$ 10,656,866</u>
<b>Other income:</b>		
Simulation and Training Division .....	\$ 338,900	\$ —
Armor Division .....	—	—
Battery and Power Systems Division ...	—	—
All Other .....	—	—
	<u>\$ 338,900</u>	<u>\$ —</u>
<b>Financial expense (income):</b>		
Simulation and Training Division .....	\$ 22,294	\$ 27,842
Armor Division .....	(2,463)	13,503
Battery and Power Systems Division ...	122,236	54,511
All Other .....	2,563,622	4,133,109
	<u>\$ 2,705,689</u>	<u>\$ 4,228,965</u>
<b>Tax expenses:</b>		
Simulation and Training Division .....	\$ 63,976	\$ 77,811
Armor Division .....	94,671	134,949
Battery and Power Systems Division ...	32,846	320,878
All Other .....	46,179	52,471
	<u>\$ 237,672</u>	<u>\$ 586,109</u>
<b>Amortization of intangible assets:</b>		
Simulation and Training Division .....	\$ 1,213,261	\$ 1,323,403
Armor Division .....	1,348,248	661,914
Battery and Power Systems Division ...	509,239	509,239
	<u>\$ 3,070,748</u>	<u>\$ 2,494,556</u>
<b>Impairment of goodwill and other intangible assets:</b>		
Simulation and Training Division .....	\$ —	\$ 320,279
Armor Division .....	12,256,756	—
Battery and Power Systems Division ...	—	—
	<u>\$ 12,256,756</u>	<u>\$ 320,279</u>
<b>Loss from affiliated company:</b>		
Simulation and Training Division .....	\$ (75,000)	\$ —
Armor Division .....	—	—
Battery and Power Systems Division ...	—	—
	<u>\$ (75,000)</u>	<u>\$ —</u>
<b>Minority interest in loss (profit) of subsidiaries:</b>		
Simulation and Training Division .....	\$ —	\$ —
Armor Division .....	57,149	(44,694)
Battery and Power Systems Division ...	—	—
	<u>\$ 57,149</u>	<u>\$ (44,694)</u>



	Year Ended December 31,	
	2005	2004
<b>Income (loss) from continuing operations:</b>		
Simulation and Training Division .....	\$ 3,170,091	\$ 1,541,775
Armor Division .....	(15,678,786)	(222,485)
Battery and Power Systems Division....	(869,178)	(661,166)
All Other .....	(10,545,538)	(9,700,437)
	<u>\$ (23,923,411)</u>	<u>\$ (9,042,313)</u>
<b>Loss from discontinued operations:</b>		
Simulation and Training Division .....	\$ —	\$ —
Armor Division .....	—	—
Battery and Power Systems Division....	(120,000)	—
	<u>\$ (120,000)</u>	<u>\$ —</u>
<b>Net income (loss):</b>		
Simulation and Training Division .....	\$ 3,170,091	\$ 1,541,775
Armor Division .....	(15,678,786)	(222,485)
Battery and Power Systems Division....	(989,178)	(661,166)
All Other .....	(10,545,538)	(9,700,437)
	<u>\$ (24,043,411)</u>	<u>\$ (9,042,313)</u>

### **Fiscal Year 2005 compared to Fiscal Year 2004**

**Revenues.** During 2005, we recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force and driver operator training systems and from the provision of maintenance services in connection with such systems;
- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products;
- EFB and Epsilon recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army; and
- EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase IV of the United States Department of Transportation (DOT) electric bus program.

Revenues for the year ended December 31, 2005 totaled \$49.0 million, compared to \$50.0 million for 2004, a decrease of \$949,000, or 2%. This decrease was primarily attributable to the decreased revenues of our Armor Division, specifically decreased revenues of MDT Armor (\$5.1 million during 2005 compared to \$13.4 million in 2004).

These decreased revenues were offset to some extent by increased revenues from our Simulation and Training Division (\$26.8 million in 2005 compared to \$21.5 million in 2004), due primarily to the increased revenues of FAAC.

In 2005, revenues were as follows:

- \$26.8 million for the Simulation and Training Division, compared to \$21.5 million in 2004, an increase of \$5.3 million, or 25%, due primarily to the increased revenues of FAAC (approximately \$4.5 million).
- \$12.3 million for the Armor Division, compared to \$18.0 million in 2004, a decrease of \$5.7 million, or 32%, due primarily to the decreased revenues from MDT Armor (approximately \$8.3 million) as a result of a slowdown in armoring orders related to the Iraq War. This decrease was partially offset by higher revenues recorded by us in 2005 from AoA in comparison to 2004, due to the fact that AoA's revenues were included for all of 2005 but only for the last five months of 2004. On a pro forma basis, AoA's revenues decreased in 2005 versus 2004, due to decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan, and, following Hurricane Katrina, the fact that substantial funds earmarked for defense were delayed to provide funds for hurricane relief.
- \$9.9 million for the Battery and Power Systems Division, compared to \$10.5 million in 2004, a decrease of \$585,000, or 6%, due primarily to decreased sales of lithium batteries and chargers by our Epsilon subsidiary as a result of reduced equipment purchases by one of its customers, offset to some extent by increased revenues from our Zinc-Air military batteries.

**Cost of revenues and gross profit.** Cost of revenues totaled \$34.4 million during 2005, compared to \$34.0 million in 2004, an increase of \$373,000, or 1%, due primarily to increased cost of goods sold related to the write off of inventory in the Armor Division in the amount of \$1.1 million in 2005.

Direct expenses for our three divisions during 2005 were \$22.0 million for the Simulation and Training Division, compared to \$17.9 million in 2004, an increase of \$4.1 million, or 23%, due primarily to the addition of expenses associated with increased sales of driver training systems through FAAC (approximately \$4.5 million), offset to some extent by decreased expenses associated with the sales of use-of-force training systems; \$14.0 million for the Armor Division,



compared to \$16.4 million in 2004, a decrease of \$2.5 million, or 15%, due primarily to decreased revenues of MDT Armor (\$5.1 million during 2005 compared to \$13.4 million in 2004), offset to some extent by increased expenses associated with AoA, including inventory write-off; and \$9.8 million for the Battery and Power Systems Division, compared to \$10.0 million in 2004, a decrease of \$217,000, or 2%, due primarily to decreased revenues from Epsilon.

Gross profit was \$14.7 million during 2005, compared to \$15.9 million during 2004, a decrease of \$1.3 million, or 8%. This decrease was the direct result of all factors presented above, most notably the decrease in revenues and margins from MDT Armor and Epsilon and the inventory write-off in the amount of \$1.1 million in our Armor Division, offset to some extent by an increase in gross profit from our Simulation and Training Division.

**Research and development expenses.** Research and development expenses for 2005 were \$1.3 million, compared to \$1.7 million in 2004, a decrease of \$431,000, or 25%. This decrease was primarily attributable to allocating research and development expenses to the cost of revenues due to research and development contracts in the Battery and Power Systems Division and due to higher capitalization of software in the amount of \$286,000 in 2005 compared to 2004.

**Sales and marketing expenses.** Sales and marketing expenses for 2005 were \$4.5 million, compared to \$4.9 million in 2004, a decrease of \$451,000, or 9%. This decrease was primarily attributable to the decrease in sales commissions in the Battery and Power Systems Division.

**General and administrative expenses.** General and administrative expenses for 2005 were \$14.9 million, compared to \$10.7 million in 2004, an increase of \$4.2 million, or 39%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of AoA in our results for all of 2005 but only five months of 2004 (\$836,000);
- Increases in general and administrative expenses in our FAAC subsidiary due to legal expenses, employee relocation, accounting, incentive pay accruals, and similar expenses (\$809,000);

- Increase in other corporate general and administrative expenses such as auditing, legal and travel expenses (\$800,000); and
- Increase in costs related to abandoned acquisition activities (\$1.1 million).

**Financial expenses, net.** Financial expense, net of interest income and exchange differentials, totaled approximately \$2.7 million in 2005, compared to \$4.2 million in 2004, a decrease of \$1.5 million, or 36%. This decrease was due primarily to the decreased amortization of compensation related to warrants issued to the holders of convertible debentures and related beneficial conversion feature.

**Income taxes.** We and certain of our subsidiaries incurred net operating losses during 2005 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 2005, we were able to offset federal taxes against our net operating loss carry forwards. We recorded a total of \$238,000 in tax expenses in 2005, with respect to certain of our subsidiaries that operated at a net profit during 2005 and we are not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes. 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 were not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes.

**Amortization of intangible assets.** Amortization of intangible assets totaled \$3.1 million in 2005, compared to \$2.5 million in 2004, an increase of \$576,000, or 23%, due primarily to amortization of intangible assets related to our AoA subsidiary that we acquired in August 2004.

**Impairment of goodwill and other intangibles assets.** Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our 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.



During 2005, we performed an impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows, as a response to several factors, including without limitation the reduced sales in AoA (a component of our Armor Division), the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA us, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular – specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), and the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, substantial funds earmarked for defense were delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, we identified in AoA an impairment of goodwill in the amount of \$11.8 million.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with current accounting standards 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, we identified an impairment of the technology previously purchased from Bristlecone and, as a result, we recorded an impairment loss in the amount of \$320,000. As of December 31, 2005, we identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$499,000.

**Loss from continuing operations.** Due to the factors cited above, we reported a loss from continuing operations of \$23.9 million in 2005, compared to \$9.0 million in 2004, an increase of \$14.9 million, or 165%.

**Loss from discontinued operations.** Net loss from discontinued operations for 2005 was \$120,000 compared to \$0 in 2004. This is because

during the second quarter of 2005 we took an accrual of \$200,000 for a litigation contingency related to the discontinued operations; in March 2006, this litigation was settled for \$120,000.

**Net loss before deemed dividend of common stock to certain stockholders.** Due to the factors cited above, we reported a net loss of \$24.0 million in 2005, compared to a net loss of \$9.0 million in 2004, an increase of \$15.0 million, or 166%.

**Net loss after deemed dividend of common stock to certain stockholders.** In 2004 we had a deemed dividend of \$3.3 million (see Notes 13.f.3. and 13.f.4. to the financial statements) that we did not have in 2005. Accordingly, net loss after deemed dividend of common stock to certain stockholders was \$24.0 million in 2005, compared to \$12.4 million in 2004, an increase of \$11.7 million, or 94%.

#### **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 Epsilon);
- 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 Training 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 Training 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 Training 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 with certain potential acquisitions, which 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.

**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 and impairment.** 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 13.f.3. and 13.f.4. to the financial statements) compared to \$9.6 million in 2003, an increase of 2.8 million, or 29%.

## Liquidity and Capital Resources

As of December 31, 2005, we had \$6.2 million in cash, \$3.9 million in restricted collateral securities and restricted held-to-maturity securities due within one year, \$779,000 in long-term restricted deposits, and \$36,000 in available-for-sale marketable securities, as compared to at December 31, 2004, when 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.

We used available funds in 2005 primarily for sales and marketing, continued research and development expenditures, expenses in connection with acquisitions and proposed acquisitions, and other working capital needs. We increased our investment in fixed assets by \$1.2 million during the year ended December 31, 2005, primarily in the Battery and Power Systems Division and in the Simulation and Training Division. Our net fixed assets amounted to \$4.3 million as at year end.

Net cash used in operating activities for 2005 and 2004 was \$11.8 million and \$852,000, respectively, an increase of \$10.2 million. This increase was primarily the result of increased loss in 2005 and an increase in trade receivables and decrease in trade payables and other account payables.



Net cash used in investing activities for 2005 and 2004 was \$11.8 million and \$50.5 million, respectively, a decrease of \$38.7 million. This decrease was primarily the result of our investment in the acquisition of FAAC, Epsilon and AoA in 2004.

Net cash provided by financing activities for 2005 and 2004 was \$22.2 million and \$44.4 million, respectively, a decrease of \$22.1 million. This decrease was primarily the result of lower amounts of funds raised through sales of our securities in 2005 compared to 2004.

During 2005, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately \$17,000.

We have approximately \$8.8 million in long-term debt outstanding (not including accrued severance pay). All of this debt was convertible debt; the unamortized financial expenses related to the beneficial conversion feature of this convertible debt amounted to approximately \$160,000 at year end. We also have approximately \$15.5 million in short-term debt (not including trade payables and other accounts payable), of which \$604,000 relates to the earn-out provision in connection with our acquisition of FAAC and \$12.8 million relates to short-term convertible debt.

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, anticipated cash flows from operations, lines of credit and anticipated additions to paid-in capital should be sufficient to satisfy our current estimated cash requirements through the next twelve months. This belief is based on certain earnout and other assumptions that our management and our subsidiaries managers believe to be reasonable, some of which are subject to the risk factors de-

tailed under "Item 1A. Risk Factors," in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission, including without limitation (i) that we will be able to refinance, restructure or convert to equity our \$12.8 million in convertible debt (debentures and notes) that is due in 2006 (which does not include \$2.0 million short-term bank credit), (ii) that our dispute with the former shareholders of FAAC will ultimately be decided substantially in our favor, (iii) that the severance and retirement benefits that we owe to certain of our senior executives will not have to be paid ahead of their anticipated schedule, and (iv) that no other earnout payments to the former shareholder of AoA will be required in excess of the funds being held by him in escrow to secure such earnout obligations. In this connection, we note that we can require the holder of our notes to convert a portion of their notes into shares of our common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. Based on the current price of our stock, we do not have a sufficient number of shares of our stock registered for resale in order to continue requiring the holders to convert a portion of their notes past a portion of the payment due May 31, 2006. We would accordingly have to file a registration statement with the SEC to register for resale more shares of our common stock in order to continue requiring conversion of our notes upon principal payment becoming due. Any delay in the registration process, including through routine SEC review of our registration statement or other filings with the SEC, could result in our having to pay scheduled principal repayments on our notes in cash, which would negatively impact our cash position and, if we do not have sufficient cash to make such payments in cash, could cause us to default on our notes. We also note that from time to time our working capital needs are partially dependent on our subsidiaries' lines of credit. In the event that we are unable to continue to make use of our subsidiaries' lines of credit for working capital on economically feasible terms, our business, operating results and financial condition could be adversely affected.

### **Effective Corporate Tax Rate**

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2005, 2004 and 2003, 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 2005, we were able to offset federal taxes



against our net operating loss carryforward, which amounted to \$26.0 million as of December 31, 2005. 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 2005, 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 34% in 2005 (less, in the case of companies that have “ap-

proved enterprise” status as discussed in Note 14 to the Notes to Financial Statements).

As of December 31, 2005, we had a U.S. net operating loss carryforward of approximately \$26.0 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2009 through 2025, and foreign net operating and capital loss carryforwards of approximately \$82.0 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, 2005, not including trade payables and other accounts payable:

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt .....	\$8,750,000	\$ —	\$ 8,750,000	\$ —	\$ —
Short-term debt .....	\$15,474,448	\$15,474,448	\$ —	\$ —	\$ —
Operating lease obligations .....	\$1,926,383	\$ 826,367	\$ 1,003,176	\$ 96,840	\$ —
Severance obligations .....	\$1,732,955	\$ 137,685	\$ 1,595,269	\$ —	\$ —

\* Includes convertible debentures in the gross amount of \$8,750,000. Unamortized financial expenses related to the beneficial conversion feature of these convertible debentures amounted to \$160,000 at year end.

\*\* Includes sums owed in respect of an earn-out provision related to our acquisition of FAAC, in the amount of \$604,000. Also includes \$12.8 million short-term convertible note and \$2.0 million in short-term bank debt

\*\*\* Includes operating lease obligations related to rent.

\*\*\*\* Includes obligations related to special severance pay arrangements in addition to the severance amounts due to certain employees pursuant to Israeli severance pay law (the amount shown in the table above with payment due during the next 1-3 years might not be paid in the period stated in the event the employment agreements to which such severance obligations relate are extended).



## CONTROLS AND PROCEDURES

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### Evaluation of Disclosure Controls and Procedures

As of December 31, 2005, 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 objectives 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.

Our management has not yet completed its assessment of the effectiveness of our internal control over financial reporting. However, based on their evaluation as of December 31, 2005 and the material weakness described 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 not 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 procedures to determine that our 2005 consolidated financial statements were 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, as such term is defined in Exchange Act Rule 13a-15(f). Our management has not yet completed its assessment of our internal control over financial reporting as of December 31, 2005, which it has been conducting pursuant to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 and using the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in *Internal Control – Integrated Framework*.

However, based on their evaluation procedures performed to date, management has identified a material weakness in our internal control over financial reporting at December 31, 2005. A material weakness is a control deficiency, or a 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.

We have identified the following material weakness as of December 31, 2005, related to our FAAC subsidiary:

- *Revenue recognition.* We did not maintain effective controls over the monitoring, review and approval of revenue recognition calculations at FAAC. Specifically, these calculations were not being reviewed by appropriate accounting personnel to determine that revenue is recognized in accordance with company policy and generally accepted accounting principles. This



material weakness affects the revenue and unbilled receivables accounts.

Because of this material weakness and any other material weaknesses management might identify upon completing its assessment, management has concluded that our internal control over financial reporting was not effective as of December 31, 2005.

Because we have not yet completed our assessment of the effectiveness of our internal control over financial reporting, our independent registered public accounting firm has disclaimed an opinion on management's assessment and disclaimed an opinion on the effectiveness of our internal control over financial reporting, as stated in their report which is included herein.

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, 2005, and their report dated March 30, 2005 expressed an unqualified opinion with respect thereto.

#### **Plans to Remediate the Material Weakness**

In response to the material weakness described above, we have undertaken 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 2006, during which we expect to

continue pursuing appropriate corrective actions at FAAC, including the following:

- *Revenue recognition.* We will institute procedures at FAAC to determine that revenue recognition calculations are reviewed by an appropriate accounting person.

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 weakness will be fully remediated. However, because remediation will not be completed until we have strengthened pertinent controls, we presently anticipate that we will report in our Quarterly Report on Form 10-Q for the first quarter of fiscal 2006 that material weakness continues to exist.

#### **Changes in Internal Controls Over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter to which this Annual Report on Form 10-K relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



**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, 2005 and 2004, 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, 2005. 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 Incorporated", a wholly-owned subsidiary of the Company, financial statements of which reflect total assets of 2.8% of the consolidated assets of the Company as of December 31, 2005, and total revenues of 8.8% of the consolidated revenues of the Company for the year then ended, or of "IES Interactive Training, Inc.", a wholly-owned subsidiary of the Company, financial statements of which reflect total assets of 3.5% of the consolidated assets of the Company as of December 31, 2005, and total revenues of 11.8% 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, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, 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.

We were also engaged to audit, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and have issued our report dated March 30, 2006, which disclaimed an opinion on the Company's internal controls over financial reporting.

Tel Aviv, Israel  
March 30, 2006KOST, FORER, GABBAY & KASIERER  
A Member of Ernst & Young Global



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM****To the Stockholders of  
AROTECH CORPORATION**

We were engaged to audit management's assessment, included in the accompanying "Management's Report on Internal Control Over Financial Reporting", of Arotech Corporation ("Arotech" or "Company") regarding the effectiveness of internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Arotech'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.

As described in the accompanying "Management's Report on Internal Control Over Financial Reporting", the Company has not yet completed its assessment of the effectiveness of internal control over financial reporting as of December 31, 2005. Accordingly, we were unable to perform auditing procedures necessary to form an opinion on management's assessment.

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.

Since management has not yet completed its assessment on internal control over financial reporting as of December 31, 2005 and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the Company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion either on management's assessment or on the effectiveness of the Company's internal control over financial reporting.

The following material weakness has been identified and included in management's assessment as of December 31, 2005, related to the Company's FAAC subsidiary:

- *Revenue recognition.* The Company did not maintain effective controls over the monitoring, review and approval of revenue recognition calculations at FAAC. Specifically, these calculations were not



being reviewed by appropriate accounting personnel to determine that revenue is recognized in accordance with company policy and generally accepted accounting principles. This material weakness affects the revenue and unbilled receivable accounts.

A material weakness is a control deficiency, or a 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 presence of a material weakness would preclude a conclusion that internal control over financial reporting is effective. The above material weakness was considered in determining the nature, timing and extent of audit tests applied in our audit of the 2005 consolidated financial statements of the Company, and this report does not affect our report dated March 30, 2006 on those financial statements.

Tel Aviv, Israel  
March 30, 2006

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





STARK 株式会社 WINTER 株式会社 SCHENKEIN

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors  
IES Interactive Training, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of IES Interactive Training, Inc. and Subsidiary as of December 31, 2005, and the related consolidated statements of operations, stockholder's (deficit) and cash flows for the year ended December 31, 2005. We also have audited management's assessment, included in the accompanying *Management's Report on Internal Control Over Financial Reporting*, that IES Interactive Training, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). IES Interactive Training, Inc. and Subsidiary's management is responsible for these consolidated financial statements, 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 these consolidated financial statements, 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 the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting 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 opinions.

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk



that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of IES Interactive Training, Inc. and Subsidiary as of December 31, 2005, and the results of its operations and its cash flows for the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that IES Interactive Training, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, IES Interactive Training, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

*Stark Winter Schenkein & Co., LLP*

Denver, Colorado  
March 10, 2006

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

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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 sheet of Armour of America, Inc. as of December 31, 2005, and the related statements of operations, stockholder's equity and cash flows for the period August 11, 2004 to December 2004 and the year ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Armour of America, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Armour of America, Inc.'s management is responsible for these financial statements, 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 these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

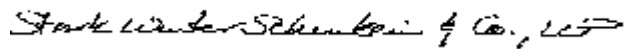
We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting 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 audits provide a reasonable basis for our opinions.

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



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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Armour of America, Inc. as of December 31, 2005, and the related statements of operations, stockholder's equity and cash flows for the period August 11, 2004 to December 2004 and the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that Armour of America, Inc. maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, Armour of America, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).



Denver, Colorado  
January 31, 2006

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

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**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

In U.S. dollars

	December 31,	
	2005	2004
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 6,150,652	\$ 6,734,512
Restricted collateral deposits and restricted held-to-maturity securities	3,897,113	6,962,110
Available for sale marketable securities	35,984	135,568
Trade receivables (net of allowance for doubtful accounts in the amounts of \$176,180 and \$55,394 as of December 31, 2005 and 2004, respectively)	11,747,876	8,266,880
Unbilled receivables	5,228,504	2,881,468
Other accounts receivable and prepaid expenses	2,264,331	1,339,393
Inventories	7,815,806	7,277,301
Total current assets	37,140,266	33,597,232
SEVERANCE PAY FUND	2,072,034	1,980,047
RESTRICTED DEPOSITS	779,286	4,000,000
PROPERTY AND EQUIPMENT, NET	4,252,931	4,600,691
INVESTMENT IN AFFILIATED COMPANY	37,500	—
OTHER INTANGIBLE ASSETS, NET	11,027,499	14,368,701
GOODWILL	29,559,157	39,745,516
	<u>\$ 84,868,673</u>	<u>\$ 98,292,187</u>

*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,	
	2005	2004
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables	\$ 5,830,820	\$ 6,177,546
Other accounts payable and accrued expenses	5,630,108	5,818,188
Current portion of promissory notes due to purchase of subsidiaries	603,764	13,585,325
Short term bank credit and current portion of long term loans	2,036,977	181,352
Deferred revenues	603,022	618,229
Convertible debenture	11,492,238	—
Liabilities of discontinued operations	120,000	—
Total current liabilities	26,316,929	26,380,640
<b>LONG TERM LIABILITIES</b>		
Accrued severance pay	3,657,328	3,422,951
Convertible debenture	8,590,233	1,754,803
Deferred revenues	—	163,781
Long term loan	—	20,891
Long-term portion of promissory note due to purchase of subsidiaries	—	980,296
Total long-term liabilities	12,247,561	6,342,722
<b>COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)</b>		
<b>MINORITY INTEREST</b>		
	38,927	95,842
<b>STOCKHOLDERS' EQUITY:</b>		
Share capital –		
Common stock – \$0.01 par value each;		
Authorized: 250,000,000 shares as of December 31, 2004 and 2003; Issued: 87,096,711 shares and 80,637,001 shares as of December 31, 2005 and 2004, respectively; Outstanding – 86,541,378 shares and 80,081,668 shares as of December 31, 2005 and 2004, respectively	870,969	806,370
Preferred shares – \$0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2005 and 2004; No shares issued and outstanding as of December 31, 2005 and 2004	—	—
Additional paid-in capital	193,949,882	189,266,103
Accumulated deficit	(142,996,964)	(118,953,553)
Deferred stock compensation	(389,303)	(1,258,295)
Treasury stock, at cost (common stock – 555,333 shares as of December 31, 2005 and 2004)	(3,537,106)	(3,537,106)
Notes receivable from stockholders	(1,256,777)	(1,222,871)
Accumulated other comprehensive income	(375,445)	372,335
Total stockholders' equity	46,265,256	65,472,983
	<u>\$ 84,868,673</u>	<u>\$ 98,292,187</u>

*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,		
	2005	2004	2003
Revenues	\$ 49,044,595	\$ 49,953,846	\$ 17,326,641
Cost of revenues	34,383,736	34,011,094	11,087,840
Gross profit	14,660,859	15,942,752	6,238,801
Operating expenses:			
Research and development, net	1,300,429	1,731,379	1,053,408
Selling and marketing expenses	4,471,590	4,922,217	3,532,636
General and administrative expenses	14,862,435	10,656,866	5,857,876
Amortization of intangible assets	3,070,748	2,494,556	864,910
Impairment of goodwill and other intangible as-			
sets	12,256,756	320,279	—
Total operating costs and expenses	35,961,958	20,125,297	11,308,830
Operating loss	(21,301,099)	(4,182,545)	(5,070,029)
Other income	338,900	—	—
Financial income (expenses), net	(2,705,689)	(4,228,965)	(4,038,709)
Loss before minorities interests in loss (earnings) of			
a subsidiaries and tax expenses	(23,667,888)	(8,411,510)	(9,108,738)
Income taxes	(237,672)	(586,109)	(396,193)
Loss from affiliated company	(75,000)	—	—
Minorities interests in loss (earnings) of a subsidiar-			
ies	57,149	(44,694)	156,900
Loss from continuing operations	(23,923,411)	(9,042,313)	(9,348,031)
Income (loss) from discontinued operations	(120,000)	—	110,410
Net loss	\$(24,043,411)	\$ (9,042,313)	\$ (9,237,621)
Deemed dividend to certain stockholders	\$ —	\$ (3,328,952)	\$ (350,000)
Net loss attributable to common stockholders	\$(24,043,411)	\$(12,371,265)	\$ (9,587,621)
Basic and diluted net loss per share from continu-			
ing operations	\$ (0.29)	\$ (0.13)	\$ (0.24)
Basic and diluted net loss per share from discon-			
tinued operations	\$ (0.00)	\$ 0.00	\$ 0.00
Basic and diluted net loss per share	\$ (0.29)	\$ (0.18)	\$ (0.25)
Weighted average number of shares used in com-			
puting basic and diluted net loss per share	82,209,300	69,933,057	38,890,174

*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 stockholders	Accumulated other comprehensive loss	Total comprehensive income (loss)	Total stockholders' 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 repricing 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)
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	\$ (9,131,406)	\$ 21,625,877

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 stockholders	Accumulated other comprehensive loss	Total comprehensive income	Total stockholders' 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
Redesignation to liability in connection with warrants granted			10,841,020)							(10,841,020)
Redesignation 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**  
**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 stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
	Shares	Amount								
Balance as of January 1, 2005	80,637,00									
1		\$ 806,370	\$189,266,10	\$ (118,953,553)	\$ (1,258,295)	\$ (3,537,10€	\$ (1,222,871)	\$372,335	\$	\$65,472,983
Issuance of shares, net.....	4,754,964	47,551	3,898,185							3,945,736
Shares issued to convertible debenture holders.....	1,161,668	11,617	441,434							453,051
Shares issued to consultant .....	507,253	5,073	516,200							521,273
Compensation related to non-recourse loan granted to shareholder.....			(28,500)							(28,500)
Employee options exercise .....	15,825	158	17,034							17,192
Shares issued to employees.....	10,000	100	(100)							—
Deferred stock compensation related to options and re-striated stock.....	50,000	500	50,500		(51,000)					—
Amortization of deferred stock compensation.....					674,712					674,712
Cancellation of deferred stock compensation as a result of forfeitures.....	(40,000)	(400)	(244,880)		245,280					—
Interest accrued on notes receivable from shareholders.....							(33,906)			—
Other comprehensive loss – foreign currency translation adjustment .....			33,906					(746,016)	(746,016)	(746,016)
Other comprehensive loss – unrealized gain on available for sale marketable securities								(1,764)	(1,764)	(1,764)
Net loss .....				(24,043,411)					(24,043,411)	(24,043,411)
Total comprehensive loss .....								\$	(24,791,191)	
Balance as of December 31, 2005	87,096,71	\$ 870,969	\$193,949,88	\$ (142,996,964)	\$ (389,303)	\$ (3,537,10€	\$ (1,256,777)	\$ (375,445)		\$ 46,265,25
1										

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,		
	2005	2004	2003
Cash flows from operating activities:			
Net loss	\$(24,043,411)	\$ (9,042,313)	\$ (9,237,621)
Less loss (profit) for the period from discontinued operations	120,000	—	(110,410)
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minorities interests in earnings (loss) of subsidiary	(57,149)	44,694	(156,900)
Loss from affiliated company	75,000	—	—
Depreciation	1,373,580	1,199,465	730,159
Amortization of intangible assets, capitalized software costs and impairment of intangible assets	15,453,584	2,888,226	879,311
Remeasurement of liability in connection to warrants granted	(377,803)	(326,839)	—
Accrued severance pay, net	68,839	(441,610)	3,693
Amortization of deferred stock compensation and compensation related to shares issued to employees	674,713	884,826	8,286
Mark up of loans to stockholders	—	(32,397)	(12,519)
Write-off of inventories	1,062,336	121,322	96,350
Impairment of property and equipment	34,243	—	68,945
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature	1,702,753	4,142,109	3,928,237
Amortization of deferred charges related to convertible debentures issuance	329,152	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	538,058	89,078	161,947
Stock-based compensation related to non-recourse note granted to stockholder	(28,500)	(10,000)	38,500
Interest accrued or paid on promissory notes due to acquisition	19,704	39,311	(66,793)
Interest accrued on restricted collateral deposits	—	(267,179)	—
Capital loss (gain) from sale of marketable securities	2,695	(4,247)	—
Amortization of premium related to restricted held to maturity securities	42,234	202,467	—
Capital loss (gain) from sale of property and equipment	3,172	(16,479)	(11,504)
Decrease (increase) in trade receivables	(3,608,950)	732,828	(820,137)
Decrease (increase) in other accounts receivable and prepaid expenses	(75,982)	(49,513)	40,520
Decrease (increase) in deferred tax assets	65,376	(89,823)	—
Increase in inventories	(1,710,528)	(2,040,854)	(193,222)
Increase in unbilled revenues	(2,347,036)	(1,581,080)	—
Decrease in deferred revenues	(178,988)	(91,271)	—
Increase (decrease) in trade payables	(224,987)	2,913,623	(986,022)
Increase (decrease) in other accounts payable and accrued expenses	32,269	(125,231)	1,677,668
Net cash used in operating activities from continuing operations	(11,055,626)	(638,155)	(3,012,290)
Net cash used in operating activities from discontinued operations	—	(214,041)	(313,454)
Net cash used in operating activities	<u>\$ (11,055,626)</u>	<u>\$ (852,196)</u>	<u>\$ (3,325,744)</u>

*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,		
	2005	2004	2003
Cash flows from investing activities:			
Purchase of property and equipment	(1,224,752)	(1,659,688)	(580,949)
Increase in capitalized software costs	(651,611)	(365,350)	(209,616)
Loans granted to stockholders	—	(1,036)	(13,737)
Repayment of loans granted to stockholders	—	32,397	9,280
Proceeds from sale of property and equipment	104,175	114,275	16,753
Proceeds from sale of marketable securities	91,936	90,016	—
Investment in marketable securities	—	(89,204)	—
Investment in affiliated company	(112,500)	—	—
Payment of transaction expenses in relation to previous year investment in subsidiary	(12,945)	—	—
Acquisition of Epsilor (1)	—	(7,190,777)	—
Acquisition of FAAC (2)	—	(12,129,103)	—
Acquisition of AoA (3)	—	(17,339,522)	—
Repayment of promissory notes related to acquisition of subsidiaries (1)(2)	(14,588,298)	(2,000,000)	(750,000)
Purchase of certain tangible and intangible assets	(150,000)	(150,000)	(196,331)
Increase in restricted cash and held to maturity securities	4,748,178	(9,809,091)	(72,840)
Net cash used in investing activities	(11,795,817)	(50,497,083)	(1,797,440)
Cash flows from financing activities:			
Proceeds from issuance of shares, net	3,945,736	24,361,750	(6,900)
Proceeds from exercise of options to employees and consultants	17,192	1,148,819	440,914
Proceeds from exercise of warrants	—	19,233,271	3,296,254
Proceeds from issuance of convertible debentures, net of issuance expenses	16,430,767	—	13,708,662
Long term loan received	—	69,638	—
Repayment of long term loan	(71,238)	(65,674)	—
Increase (decrease) in short term bank credit	1,914,892	(376,783)	(74,158)
Payment on capital lease obligation	—	(4,145)	(4,427)
Net cash provided by financing activities	22,237,349	44,366,876	17,360,345
Increase (decrease) in cash and cash equivalents	(614,094)	(6,982,403)	12,237,161
Cash erosion due to exchange rate differences	30,234	31,790	(9,562)
Cash and cash equivalents at the beginning of the year	6,734,512	13,685,125	1,457,526
Cash and cash equivalents at the end of the year	<u>\$ 6,150,652</u>	<u>\$ 6,734,512</u>	<u>\$ 13,685,125</u>
Supplementary information on non-cash transactions:			
Issuance of shares and warrants against accrued expenses and restricted deposit	<u>\$ 56,577</u>	<u>\$ 1,310,394</u>	<u>\$ —</u>
Purchase of intangible assets against note receivable	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 300,000</u>
Increase of investment in subsidiary against issuance of shares of common stock	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 123,480</u>
Conversion of promissory note to shares of common stock	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 450,000</u>
Payment of principle installment of convertible debenture in shares	<u>\$ 453,051</u>	<u>\$ —</u>	<u>\$ —</u>
Liability in connection to warrants granted	<u>\$ 44,231</u>	<u>\$ —</u>	<u>\$ —</u>
Conversion of convertible debenture to shares of common stock	<u>\$ —</u>	<u>\$ 3,837,500</u>	<u>\$ 6,125,000</u>
Benefit due to convertible debentures and warrants	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 10,853,043</u>
Accrual for earn out in regard to subsidiary acquisition	<u>\$ 603,764</u>	<u>\$ 13,435,325</u>	<u>\$ —</u>
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	<u>\$ 1,401,681</u>	<u>\$ 532,750</u>	<u>\$ 39,412</u>
Taxes on income	<u>\$ 737,080</u>	<u>\$ 969,009</u>	<u>\$ 527,053</u>

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



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Cont.)**

**In U.S. dollars**

- (1) 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
	<u>10,144,262</u>
Issuance of shares in respect to transaction costs	(12,500)
Issuance of promissory note *)	(2,940,985)
	<u>\$ 7,190,777</u>

- \*) During 2005 and 2004 amounts of \$1,000,000 and \$2,000,000, respectively, were repaid to the former shareholders of Epsilor.

- (2) 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	12,072,321
	<u>14,132,781</u>
Issuance of shares, net	(2,003,678)
	<u>\$ 12,129,103</u>

- \*) During 2005, an additional amount of \$13,588,298 was paid to the former shareholders of FAAC in respect of the earnout provisions of the acquisition agreement. The additional amount was charged to goodwill.

- (3) 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
	<u>\$ 17,339,522</u>

See note 1.d. regarding additional earnout obligation to the former shareholder of AoA.

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



# AROTECH CORPORATION AND ITS SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

### NOTE 1:– GENERAL

a. Arotech Corporation (“Arotech” or the “Company”) and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced high-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 2005, 2004 and 2003 are described in Note 16.d.

#### b. 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 con-

sisted 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	<u>\$ 10,144,262</u>

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.e. for pro forma financial information.

#### c. Acquisition of FAAC:

In January of 2004, the Company entered into a stock purchase agreement with the stockholders



# **AROTECH CORPORATION AND ITS SUBSIDIARIES** **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. Dollars

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 the Company's common stock, \$0.01 par value per share, having a value of approximately \$2.0 million. There was also an earn-out based on 2004 net pretax income. Based on FAAC's 2004 net pretax income, the Company paid the former stockholders of FAAC an earnout of \$13.6 million during 2005, in cash and through the issuance of a total of 3,479,465 shares of the Company's common stock (see Note 13.b.5.). The total consideration of \$27.7 million (including the earn-out as well as \$137,991 of transaction costs) was determined based upon arm's-length negotiations between the Company and FAAC's stockholders.

In addition, the Company has a contingent earnout obligation in an amount equal to the net income realized by the Company from certain specific programs that were identified by the Company and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. During 2005, the Company accrued an amount of \$603,764 in respect of such earnout obligation against FAAC's goodwill. Although the former shareholders of FAAC have indicated to the Company their belief that the specific programs identified include more orders than those with respect to which the Company has made accrual in respect of this earnout obligation, the Company believes there is no basis for this claim (see Note 11.e.3.).

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition (including earnout obligation accrued as of December 31, 2005) 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	19,522,343
Liabilities assumed	(2,770,843)
Total consideration	<u>\$ 28,330,053</u>

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.



# **AROTECH CORPORATION AND ITS SUBSIDIARIES** **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. Dollars

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.e. for pro forma financial information.

## d. 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. These funds are currently being held by the seller of AoA. 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 \$131,177 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 (including earnout

obligation accrued as of December 31, 2005), 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	11,757,812
Liabilities assumed	(347,770)
Total consideration	\$ 20,335,327

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 connection with the Company's acquisition of AoA, the Company has a contingent earnout obligation in an amount equal to the revenues realized by the Company from certain specific programs that were identified by the Company and the former shareholder of AoA as appropriate targets for revenue increases. The earnout provides that if AoA receives certain types of orders from certain specific customers prior to December 31, 2006 ("Additional Orders"), then upon shipment of goods in connection with such Additional Orders, the former shareholder of AoA will be paid an earnout based on revenues, up to a maximum of an additional \$6 million. During 2005, the Company accrued an amount of \$1,204,150 in respect of such earnout obligation.

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.f. for impairment information.

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

## e. Pro forma results

In January 2004, the Company acquired FAAC and Epsilor, as more fully described in "Note 1.b. – Acquisition of Epsilor" and "Note 1.c. – Acquisition of FAAC," above, in August 2004, the Company acquired AoA, as more fully described



# **AROTECH CORPORATION AND ITS SUBSIDIARIES** **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. Dollars

in "Note 1.d. – Acquisition of AoA," above (the "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.

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.

	<b>Year Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
	(Unaudited)	
Total revenues .....	\$ 61,086,697	\$ 39,680,394
Gross profit .....	22,528,254	17,214,249
Net loss .....	(5,810,114)	(6,959,174)
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)
Basic and diluted net loss per share .....	\$ (0.13)	\$ (0.14)
Weighted average number of shares used in computing basic net loss per share .....	69,933,057	52,966,330

f. Impairment of goodwill and other intangible assets:

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement, at least annually thereafter, and 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.

During 2005, the Company performed impairment test of goodwill, based on management's projections and using expected future dis-

counted operating cash flows and as response to several factors, including without limitation the reduced sales in AoA (a component of the Company's Armor Division) the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA and the Company, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular; specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, substantial funds earmarked for defense were delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, the Company identified in AoA an impairment of goodwill in the amount of \$11,757,812.

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 \$320,279. As of December 31, 2005 the Company identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and as a result recorded an impairment loss in the amount of \$498,944.

## **NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements have been prepared in accordance with generally accepted



## AROTECH CORPORATION AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. Dollars

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 and its subsidiaries' affiliates 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 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 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 which are used as a security for the Company's guarantee performance, its liability to a former shareholder of its acquired subsidiary and for the company's liability for interest payments related to its convertible debentures.

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 Investments 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, 2005 the Company and its subsidiaries classified its investment in marketable securities as available-for-sale.

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 2005, 2004 and 2003, the Company wrote off \$1,062,336, \$121,322 and \$96,350 of obsolete inventory respectively, which has been included in the cost of revenues.

Cost is determined as follows:



# **AROTECH CORPORATION AND ITS SUBSIDIARIES** **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. Dollars

Raw and packaging materials – by the average cost method.

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

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

## **h. Property and equipment:**

Property and equipment are stated at cost net of accumulated depreciation and investment grants received from the State of Israel for investments in fixed assets under the Investment Law (no investment grants were received during 2005, 2004 and 2003).

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.

See Note 1.f. regarding the impairment test.

## **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

See Note 1.f. regarding the impairment test.

## **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 2005, 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 (Simulation and 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



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U.S. Army (Battery and Power Systems Division); and (iv) from the sale of lifejacket lights (Battery and Power Systems Division).

Revenues from the Battery and Power Systems 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 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, 2005, \$485,877 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 it is 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.

#### I. 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.



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m. Warranty:

The Company offers up to one year warranty for most of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the Company does business. The Company estimates the costs that may be incurred under its basic limited warranty, including parts and labor. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs as the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. As of December 31, 2005, warranty liability is not material.

n. Research and development cost:

SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires capitalization of certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred, when applicable. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release, have been capitalized. Capitalized software costs will be amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software bears to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (two 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 undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2005

o. 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 its estimated realizable value.

p. 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.



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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.

**q. 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 35,894,854, 31,502,158 and 22,194,211 for the years ended December 31, 2005, 2004 and 2003, respectively.

**r. 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 4.28%, 3.63% and 2.54% for 2005, 2004 and 2003, 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 0.76 for 2005, 0.81 for 2004 and 0.67 for 2003; and a weighted-average expected life of the option of three years for 2005, and five years for 2004 and 2003.

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,		
	2005	2004	2003
Net loss as reported	\$ (24,043,411)	\$ (9,042,313)	\$ (9,237,621)
Add: Stock-based compensation expenses included in reported net loss	674,712	831,626	8,286
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(2,461,787)	(2,741,463)	(1,237,558)
	<u>\$ (25,830,486)</u>	<u>\$ (10,952,150)</u>	<u>\$ (10,466,893)</u>
Loss per share:			
Basic and diluted, as reported	\$ (0.29)	\$ (0.18)	\$ (0.25)
Diluted, pro forma	<u>\$ (0.31)</u>	<u>\$ (0.16)</u>	<u>\$ (0.27)</u>

**s. Fair value of financial instruments:**

The following methods and assumptions were used by the Company and its subsidiaries in es-

timating their fair value disclosures for financial instruments:



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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-term 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.

t. 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, 2005 and 2004, the accumulated severance pay in that regard amounted to \$1,732,955 and \$1,642,801, respectively.

Pursuant to the terms of the employment agreement between the Company and its Chief Executive Officer, funds to secure payment of the Chief Executive Officer's contractual severance are to be deposited in a Rabbi Trust for the benefit of the Chief Executive Officer, with payments to the Rabbi Trust to be made pursuant to an agreed-upon schedule. As of December 31, 2005, the balance of this Rabbi Trust was \$454,859. Pursuant to the terms of the Rabbi Trust, funds in the Rabbi Trust continue to be owned by the Company, which benefits from all

gains and bears the risk of all losses resulting from investments of Rabbi Trust funds.

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, 2005, 2004 and 2003 amounted to \$639,952, \$460,178 and \$219,857, respectively.

u. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2005, 2004 and 2003 was approximately \$149,781, \$13,271 and \$34,732, respectively.

v. New accounting pronouncements:

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payments" ("SFAS 123(R)"), which is a revision of FASB No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for the Company in the first interim period beginning after December 15, 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.



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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 plans to adopt SFAS No. 123(R) using the modified prospective method.

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 the Company’s result of operations, although it will have no impact on the Company’s 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 2.r. 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 March 2005, the SEC released Staff Accounting Bulletin No. 107, “Share-Based Payment” (“SAB 107”). SAB 107 provides the SEC staff position regarding the application of SFAS No. 123R. SAB 107 contains interpretive guidance related to the interaction between SFAS No. 123R and certain SEC rules and regulations, as well as provides the Staff’s views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. The Company expects that the adoption of SAB 107 will have an impact on its results of operations and net earnings per share as the Company will be required to expense the fair value of all share-based payments.

In May 2005, the FASB issued Statement of Financial Accounting Standard No. 154 (“FAS

154”), “Accounting Changes and Error Corrections,” a replacement of APB No. 20, “Accounting Changes” and FAS No. 3, “Reporting Accounting Changes in Interim Financial Statements.” FAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. FAS 154 requires retrospective application to prior periods’ financial statements of a voluntary change in accounting principle unless it is impracticable. FAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company is currently assessing the impact of FAS 154 on its results of operations, financial condition and liquidity.

In November 2004, the FASB issued Statement of Financial Accounting Standard No. 151, “Inventory Costs, an Amendment of ARB No. 43, Chapter 4.” (“SFAS No. 151”). SFAS No. 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 No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of SFAS No. 151 will have a material effect on its financial position or results of operations

In November 2005, the FASB issued FASB Staff Position (“FSP”) Financial Accounting Standard (“FAS”) 115-1 and FAS 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (“FSP 115-1”), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 is required to be applied to reporting periods



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beginning after December 15, 2005 and is required to be adopted by the Company in the second quarter of fiscal 2006. The Company does not expect the adoption of FSP 115-1 to have a significant effect on its consolidated financial statements.

w. Reclassification:

Certain prior period amounts have been reclassified to conform to the current period presentation.

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

	December 31,	
	2005	2004
Short-term:		
Restricted, held to maturity, bonds in connection with FAAC earn out (Note 1.c.) <sup>(1)</sup>	\$ —	\$ 5,969,413
AoA earn out (Note 1.d.)	1,795,850	—
Deposits in connection with FAAC projects	548,973	650,989
Restricted cash in connection with interest payment to convertible debenture holders	1,395,079	—
Other	157,211	341,708
Total short-term	3,897,113	6,962,110
Long-term:		
Restricted cash in connection with interest payment to convertible debenture holders	779,286	—
Restricted cash in connection with AoA earn out (Note 1.d.)	—	3,000,000
Restricted deposit in connection with Epsilor acquisition (Note 1.b.)	—	1,000,000
Total long-term	779,286	4,000,000
	<u>\$ 4,696,399</u>	<u>\$10,962,110</u>

(1) The following is a summary of held-to-maturity securities at December 31, 2005 and 2004:

	Amortized cost		Unrealized losses		Estimated fair value	
	2005	2004	2005	2004	2005	2004
Obligations of States and political subdivisions	\$ —	\$1,012,787	\$ —	\$ (1,870)	\$ —	\$1,010,917
Corporate obligations	—	4,956,626	—	(11,966)	—	4,944,660
	<u>\$ —</u>	<u>\$5,969,413</u>	<u>\$ —</u>	<u>\$ (13,836)</u>	<u>\$ —</u>	<u>\$5,955,577</u>

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, 2005 and 2004:

	Cost		Unrealized gains		Estimated fair value	
	2005	2004	2005	2004	2005	2004
Available for sale marketable securities	\$ 32,558	\$ 130,061	\$ 3,246	\$ 5,507	\$ 35,984	\$ 135,568



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**NOTE 5:— OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES**

	December 31,	
	2005	2004
Government authorities	\$ 460,265	\$ 433,427
Employees	65,735	217,948
Prepaid expenses	1,360,589	490,357
Deferred taxes	64,820	135,482
Other	312,922	62,179
	<u>\$ 2,264,331</u>	<u>\$ 1,339,393</u>

**NOTE 6:— INVENTORIES**

	December 31,	
	2005	2004
Raw and packaging materials	\$ 3,296,453	\$ 3,969,400
Work in progress	3,697,361	1,996,139
Finished products	821,992	1,311,762
	<u>\$ 7,815,806</u>	<u>\$ 7,277,301</u>

**NOTE 7:— PROPERTY AND EQUIPMENT, NET**

a. Composition of property and equipment is as follows:

	December 31,	
	2005	2004
Cost:		
Computers and related equipment	\$ 3,081,029	\$ 3,374,695
Motor vehicles	704,718	653,255
Office furniture and equipment	786,958	872,804
Machinery, equipment and installations	7,716,598	7,464,470
Leasehold improvements	1,399,683	1,321,025
Demo inventory	369,995	141,961
	<u>\$ 14,058,981</u>	<u>13,828,210</u>
Accumulated depreciation:		
Computers and related equipment	2,328,549	2,581,689
Motor vehicles	233,745	197,071
Office furniture and equipment	474,127	494,181
Machinery, equipment and installations	5,729,563	5,143,186
Leasehold improvements	974,666	811,392
Demo inventory	65,400	
	<u>9,806,050</u>	<u>9,227,519</u>
Depreciated cost	<u>\$ 4,252,931</u>	<u>\$ 4,600,691</u>

b. Depreciation expense amounted to \$1,308,180, \$1,199,465 and \$730,159 for the years ended December 31, 2005, 2004 and 2003, respectively.

As for liens, see Note 11.d.



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**NOTE 8:– OTHER INTANGIBLE ASSETS, NET**

a.

	Year ended December 31,	
	2005	2004
Cost:		
Technology	\$ 6,841,746	\$ 6,841,746
Capitalized software costs	1,226,579	574,967
Backlog	2,194,000	2,194,000
Covenants not to compete	359,000	359,000
Customer list	7,548,645	7,548,645
Certification	246,969	246,969
	18,416,939	17,765,327
Exchange differences	(171,587)	125,455
Less - accumulated amortization	(7,267,630)	(4,391,081)
Amortized cost	(819,223)	13,499,701
Trademarks	10,158,499	869,000
	<u>869,000</u>	<u>\$14,368,701</u>

b. Amortization and impairment expenses amounted to \$3,695,772, \$2,888,226 and \$879,311 for the years ended December 31, 2005, 2004 and 2003.

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

	Year ended December 31,
2006	\$ 1,825,331
2007	1,381,883
2008	1,276,075
2009	1,235,632
2010 and forward	3,467,873
	<u>\$ 9,186,794</u>

**NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS**

The Company has a \$5.2 million authorized credit line from certain banks, of which \$206,000 is denominated in NIS and carries an interest rate of approximately prime + 2.8% and \$5.0 million of which is denominated in dollars and carries an interest rate of prime + 0.25%. As of December 31, 2005, \$4.0 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 an automobile purchase loan, that will be repaid in June 2006. This loan is denominated in NIS and carries an interest rate of 6.0%. The loan is secured by the automobile purchased with the proceeds of the loan.

**NOTE 10:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	December 31,	
	2005	2004
Employees and payroll accruals	\$ 1,443,154	\$ 1,534,295
Accrued vacation pay	485,877	469,527
Accrued expenses	504,342	1,770,348
Minority balance	1,788,558	243,116
Government authorities	172,871	1,036,669
Litigation settlement accrual <sup>(1)</sup>	439,975	–
Advances from customers	795,331	746,819
Other	–	17,414
	<u>\$ 5,630,108</u>	<u>\$ 4,030,411</u>



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### NOTE 11:– 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, 2005, 2004 and 2003 to the OCS amounted to \$28,502, \$17,406 and \$435, respectively.

As of December 31, 2005, the total contingent liability to the OCS was approximately \$10,261,000. 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. Binational 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, 2005.

As of December 31, 2005, 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:

	<u>Year ended December 31</u>
2006	\$ 826,367
2007	\$ 685,552
2008	\$ 213,909
2009	\$ 103,715
2010	\$ 96,840

Total rent expenses for the years ended December 31, 2005, 2004 and 2003 were approximately \$1,022,396, \$868,900 and \$484,361, respectively.

#### c. Guarantees:

The Company obtained bank guarantees in the amount of \$202,000 in connection (i) obligations of two of the Company's subsidiaries to the Israeli customs authorities and (ii) obligation of one of the Company's subsidiaries to secure inventory received from one of its customers. In addition, the Company issued a letter of credit in amount of \$2,000,000 to one of its subsidiary's customers.

The Company's active United States subsidiaries act as guarantors of the Company's obligations under its senior secured convertible notes.

#### d. Liens:

As security for compliance with the terms related to the investment grants from the State of Israel, EFL and Epsilon 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).

The Company has granted to the holders of its senior secured convertible notes (i) a second position security interest in the stock of MDT Armor Corporation, IES Interactive Training, Inc. and M.D.T. Protective Industries, Ltd. (junior to the security interest of the holders of its 8% secured convertible debentures) and in the assets



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of FAAC Incorporated (junior to the security interest of a bank that extends to FAAC Corporation a \$5 million line of credit) and in any stock that the Company acquires in future Acquisitions (as defined in the securities purchase agreement) and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries.

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 \$5.0 million line of credit secured by all of its accounts receivable, unbilled revenues and inventory.

Epsilon 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 7 regarding automobiles purchased in EFL and Epsilon.

e. Litigation and other claims:

As of December 31, 2005, 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:

1. 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 procurement 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.

2. 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 anti-trust 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. A motion to dismiss brought by FAAC and the municipal transport agency is pending. 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.

3. The Company has received a preliminary indication that there may be a dispute regarding the amount that it owes the former shareholders of FAAC Incorporated in respect of their earnout for 2005. Pursuant to the purchase agreement and a side letter, the Company is obligated to pay the former shareholders of FAAC an amount equal to "the net income realized by FAAC Incorporated from the Stryker Driver Simulator Program with the U.S. Army." Subsequently, the U.S. Army added additional programs, all of which it classified generally as the "Common Driver Training Program" (CDT). The former shareholders of FAAC have indicated their belief that the 2005 earnout is due on the entire CDT program, which would equal an additional amount of \$3.5 million. The Company, on advice of counsel, takes the position that the 2005 earnout is due only on the Stryker part of the CDT program, relying on the specific language of the side letter. While this is a factual issue as to which there can be no clear answer, the Company believes it has the stronger argument in this matter. Based on the Company's and its counsel's position, the Company accrued the amount of \$603,764 in respect of 2005 earnout as of December 31, 2005.

#### NOTE 12:- 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



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tures 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 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 2004, the Company recorded expenses of \$372,600 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 of December 31, 2005, principal amount of \$150,000 remained outstanding under these debentures.

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 2004, an aggregate of principal amount \$1,075,000 in 8% secured convertible debentures was converted into an aggregate of 934,784 shares.

During 2004 and 2005, the Company recorded expenses of \$613,263 and 29,603, respectively, of which \$191,895 and 29,603, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$421,368 and 0, 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.



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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 of December 31, 2005, principal amount of \$4,387,500 remained outstanding under these convertible debentures.

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 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 13.f.3.

During 2004 and 2005, the Company recorded expenses of \$3,156,246 and \$1,562,378, respectively, of which \$1,782,561 and \$1,562,378, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$1,373,685 and

\$0, respectively, was attributable to amortization due to conversion of the convertible debenture into shares.

d. Senior Secured Convertible Notes due March 31, 2008

Pursuant to the terms of a Securities Purchase Agreement dated September 29, 2005 (the "Purchase Agreement") by and between the Company and certain institutional investors, the Company issued and sold to the investors an aggregate of \$17.5 million principal amount of senior secured notes having a final maturity date of March 31, 2008.

Under the terms of the Purchase Agreement, the Company granted the investors (i) a second position security interest in the stock of MDT Armor Corporation, IES Interactive Training, Inc. and M.D.T. Protective Industries, Ltd. (junior to the security interest of the holders of the Company's 8% secured convertible debentures due September 30, 2006) and in the assets of FAAC Incorporated (junior to a bank that extends to FAAC Incorporated a \$5 million line of credit) and in any stock that the Company acquires in future acquisitions, and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries. The Company's active United States subsidiaries are also acting as guarantors of the Company's obligations under the Notes.

As of December 31, 2005, principal amount of \$17.0 million remained outstanding under these convertible notes.

The Notes are convertible at the investors' option at a fixed conversion price of \$1.00. The Notes bear interest at a rate equal to six month LIBOR plus 6% per annum, subject to a floor of 10% and a cap of 12.5%. The Company will repay the principal amount of the Notes over a period of two and one-half years, with the principal amount being amortized in twelve payments payable at the Company's option in cash and/or stock, provided certain conditions are met. In the event the Company elects to make such payments in stock, the price used to determine the number of shares to be issued will be calculated using an 8% discount to the average trading price of the Company's common stock during 17 of the 20 consecutive trading days ending two days before the payment date.

As a further part of the Securities Purchase Agreement dated September 29, 2005, the



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Company issued warrants, which are not exercisable for the six month period following closing, to purchase up to 5,250,000 shares of common stock (30% warrant coverage) at an exercise price of \$1.10 per share. These warrants are exercisable until the one-year anniversary of the effective date of the registration statement registering the shares of common stock underlying the warrants.

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" ("EITF 00-27"). The fair value of the warrants granted in respect of convertible debentures was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.87%, a volatility factor 53%, dividend yields of 0% and a contractual life of one year.

In connection with these convertible notes, the Company recorded a deferred debt discount of \$422,034 with respect to 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 – March 31, 2008 – or the actual conversion date, if earlier, as financial expenses.

The Company has also considered EITF No. 05-2, "The Meaning of Conventional Convertible Debt Instrument" in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." Accordingly, the Company has concluded that these convertible notes would be considered as conventional convertible debt and therefore EITF 00-19 do not apply to them.

As to EITF 00-19, since the terms of the warrants referred to above provided that upon exercise of a warrant the Company could issue only stock that had been registered with the SEC (which occurred in December 2005) and therefore freely tradable, 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. The fair value of these warrants was remeasured as at December 31, 2005 using the Black-Scholes pricing model assuming a risk free interest rate of 3.87%, a

volatility factor of 64%, dividend yields of 0% and a contractual life of approximately nine months. The change in the fair value of the warrants between the date of the grant and December 31, 2005 in the amount of \$377,803 has been recorded as finance income.

During 2005, the Company recorded expenses of \$110,771 attributable to amortization of the deferred debt discount arising from the fair value allocation of the warrants.

The Company's Notes provide for repayment in twelve equal installments. Installments may be paid in cash or, at the Company's option (subject to certain conditions), in stock. If the Company elects to make a payment in stock, it must give notice 24 trading days prior to the date the installment is due, and issue shares of its stock to the holders of the Note based on a conversion price of \$1.00. Thereafter, based on a price of 92% of the average price of the stock during 17 of the trading days between the notice date and the installment payment date, the Company issues additional shares based on the amount, if any, by which the average price of the stock was less than \$1.00. In December 2005, pursuant to the terms of the Notes, the Company made the first installment of a scheduled \$1,458,333 principal repayment in shares of common stock by requesting its stock transfer agent to issue a total of 1,458,335 shares to the holders of the notes. Of these shares, 1,161,668 shares were issued prior to December 31, 2005, which at the share value assigned pursuant to the procedures established in the notes was equal to repayment of \$453,051, and the remaining 296,667 shares were, for technical reasons, issued in early January 2006.

e. 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



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refusal will materially limit the Company's ability to undertake future financings.

**NOTE 13:— 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 and in respect of acquisitions:**

1. 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.

2. 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 several institutional (see also Note 13.f.2.). Finance expenses in connection with this issuance totaled \$692,500.

3. 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 13.f.3.).

4. In May 2005, the Company issued an aggregate of 1,275,500 shares of common stock at a price of \$1.00 per share, or a total purchase price of \$1,275,500, to several institutional investors.

5. In connection with the satisfaction by the Company of the provision of the FAAC purchase agreement related to an earn-out based on 2004 net pretax income, the Company, in May 2005, issued to the former shareholders of FAAC a total of 3,479,464 shares, which together with cash paid by the Company to the former shareholders of FAAC, was sufficient to satisfy the Company's obligation in respect of this earn-out provision.

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

1. 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.

2. 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.

3. 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

4. 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.



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5. 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.

6. 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 and \$64,839 during the years 2004 and 2005, respectively, and included this amount in general and administrative expenses.

7. In May 2005, the Company issued 72,653 shares of common stock to a consultant as commissions on battery orders as a part of a marketing agreement with the consultant whereby he helped procure orders and ensured payment by a specified military agency for Zinc-Air batteries and complementary products. 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 \$89,363 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company accrued compensation expenses of \$56,577 and \$32,786 during the years 2004 and 2005, respectively, and included these amounts in selling and marketing expenses.

8. In August 2005, pursuant to the terms of agreements between the Company and an investment banker, the Company issued an aggregate of 425,000 shares of common stock as part of the fee arrangements in connection with investment banking and financial consulting services that the investment banker rendered to it including arranging financing in connection with

potential acquisitions. 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 \$423,750 in accordance with EITF 96-18. In accordance with EITF 96-18 the Company accrued compensation expenses of \$423,750 during 2005 and included this amount in general and administrative expenses.

9. In August 2005, pursuant to the terms of an agreement between the Company and a public relations firm, the Company issued 9,600 shares of common stock as part of the fee arrangements in connection with investor relations services that the public relations firm rendered to it. 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 \$8,160 in accordance with EITF 96-18. In accordance with EITF 96-18 the Company accrued compensation expenses of \$8,160 during 2005 and included this amount in general and administrative expenses.

10. See Note 13.f.5.

d. Issuance of shares to lenders

As part of the securities purchase agreement on December 31, 2002 (see Note 12.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. 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



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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.

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.

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 13.b.2. and 13.f.3.

2. In connection with the Securities Purchase Agreement referred to in Note 13.b.2 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 13.f.3.

3. 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 13.f.1., 13.f.2. and 12.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 12.c. above and 7,446,811 shares were issued upon exercise of warrants issued in the transaction referred to in the Note 13.f.3. 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 13.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 13.f.1., 13.f.2. and 12.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



## AROTECH CORPORATION AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. Dollars

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.

4. 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

5. 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.

6. As of December 31, 2005, the Company's outstanding warrants totaled 22,061,463.

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 849,960 were available for future grants to employees and consultants as of December 31, 2005.



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2) 1995 Non-Employee Director Plan – 1,000,000 shares reserved for issuance, of which 210,000 stock options were issued and outstanding as of December 31, 2005. Pursuant to the terms of this Plan, no new options were issuable under this Plan after September 28, 2005.

3) 2004 Employee Option Plan – 7,500,000 shares reserved for issuance, of which 4,225,384 were available for future grants to employees and consultants as of December 31, 2005.

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 and restricted shares (except for options granted to consultants) granted as of December 31, 2005, 2004 and 2003, and changes during the years ended on those dates, is presented below:

	2005		2004		2003	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		\$		\$		\$
Options outstanding at beginning of year	9,854,761	\$ 1.19	9,018,311	\$ 1.37	5,260,366	\$ 2.26
Changes during year:						
Granted (1) (2) (3)	1,695,350	\$ 0.55	2,248,490	\$ 1.06	5,264,260	\$ 0.71
Exercised	(15,825)	\$ 1.09	(897,248)	\$ 1.24	(689,640)	\$ 0.64
Forfeited	(2,289,337)	\$ 1.89	(514,793)	\$ 3.77	(816,675)	\$ 3.51
Repriced (3)						
Old exercise price	(2,911,715)	\$ 1.10	—	—	—	—
New exercise price	2,911,715	\$ 0.39	—	—	—	—
Options outstanding at end of year	<u>9,854,760</u>	<u>\$ 0.67</u>	<u>9,854,760</u>	<u>\$ 1.19</u>	<u>9,018,311</u>	<u>\$ 1.37</u>
Options exercisable at end of year	<u>6,465,316</u>	<u>\$ 0.70</u>	<u>6,465,316</u>	<u>\$ 1.32</u>	<u>5,826,539</u>	<u>\$ 1.70</u>

(1) Includes 339,860, 936,250 and 2,035,000 options and restricted shares granted to directors and executive officers in 2005, 2004 and 2003, 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 \$51,000, \$2,081,457 and \$4,750 as of December 31, 2005, 2004 and 2003, respectively. In addition, in 2005, the Company decreased its deferred stock compensation in the amount of \$245,280 due to cancellation of certain options and restricted shares of employees that their employment was terminated. 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 2005, 2004 and 2003 was \$674,713, \$831,626 and \$8,286, respectively.

(3) On December 29, 2005 the company repriced downwards 2,911,715 options with average exercise price of \$1.1 to \$0.39. In addition, 58,875 options with exercise price of \$0.94 were forfeited and new options with exercise price of \$0.39 were given at the same day. In accordance with FIN44 the downward repricing resulted in a variable plan accounting. However, due to the decrease in the share price as of December 31, 2005 no compensation was recorded.

d. The options and restricted shares outstanding as of December 31, 2005 have been separated into ranges of exercise price, as follows:



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Range of exercise prices	Total options outstanding			Exercisable options outstanding	
	Amount	Weighted	Weighted	Amount	Weighted
	outstanding at December 31, 2005	average remaining contractual life	average exercise price	exercisable at December 31, 2005	average exercise price
\$		Years	\$		\$
0.01-2.00	8,833,349	5.10	0.53	7,868,050	0.57
2.01-4.00	226,600	3.43	2.45	109,935	2.50
4.01-6.00	170,000	4.05	4.93	170,000	4.93
6.01-8.00	5,000	1.86	6.50	5,000	6.50
8.01	10,000	1.75	9.06	10,000	9.06
	9,244,949	5.04	0.67	8,162,985	0.70

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,		
	2005	2004	2003	2005	2004	2003
Weighted average exercise prices	\$0.500	\$1.494	\$ 0.950	\$ —	\$1.672	\$ —
Weighted average fair value on grant date	\$0.260	\$1.002	\$ 0.730	\$ —	\$1.729	\$ —

2. Options issued to consultants:

a. The Company's outstanding options to consultants as of December 31, 2005, are as follows:

	2005		2004		2003	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		\$		\$		\$
Options outstanding at beginning of year	166,286	\$ 3.80	313,901	\$ 4.59	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	166,286	\$ 3.80	313,901	\$ 4.59
Options exercisable at end of year	166,286	\$ 3.80	166,286	\$ 3.80	193,901	\$ 3.46

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:

	2005	2004	2003
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, \$0 and \$29,759 for the years ended December 31, 2005, 2004 and 2003, 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.



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 14:– INCOME TAXES**

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

As of December 31, 2005, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$26 million, which are available to offset future taxable income, if any, expiring in 2009 through 2025. 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 losses 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 expired 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.



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Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 34%.

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, 2005 there are no tax exempt profits earned by Epsilor's "approved enterprises" by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2005. Furthermore, management has indicated that it has no intention of declaring any dividend.

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the existing Approved Enterprise of the Israeli subsidiary's will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Amended Investment Law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2005, the Company did not generate income under the provision of the amended Investment Law.

c. 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 34%. See also Note 14.e.

4. Tax loss carryforwards:

As of December 31, 2005, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$82 million, which are available, indefinitely, to offset future taxable income.

e. Tax rates applicable to the income of the Group companies:

Until December 31, 2003, the regular tax rate applicable to income of companies (which are not entitled to benefits due to "approved enterprise", as described above) was 36%. In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the "Knesset" (Israeli parliament) and on July 25, 2005, another law was passed,



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the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2004 - 35%, 2005 - 34%, 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

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 re-

porting 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,	
	2005	2004
Operating loss carryforward <sup>(1)</sup>	\$ 32,326,283	\$ 32,532,998
Reserve and allowance	2,222,333	1,328,479
Net deferred tax asset before valuation allowance	34,548,616	33,861,477
Valuation allowance	(34,483,796)	(33,725,995)
Total deferred tax asset	\$ 64,820	\$ 135,482
Deferred tax liability	\$ —	\$ 51,366

(1)	December 31,	
	2005	2004
Domestic	\$ 8,981,133	\$ 7,703,459
Foreign	23,345,150	24,829,539
	\$ 32,326,283	\$ 32,532,998

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, 2005 was \$757,801.

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

	Year ended December 31		
	2005	2004	2003
Domestic	\$ 21,473,366	\$ 8,006,205	\$ 7,411,121
Foreign	2,269,522	405,305	1,697,617
	\$ 23,742,888	\$ 8,411,510	\$ 9,108,738

h. Taxes on income were comprised of the following:

	Year ended December 31		
	2005	2004	2003
Current state and local taxes	\$ 83,365	\$ 539,674	\$ 44,102
Deferred taxes	14,345	(37,857)	—
Taxes in respect of prior years	139,962	84,292	352,091
	\$ 237,672	\$ 586,109	\$ 396,193
Domestic	\$ 153,950	\$ 163,087	\$ 33,020
Foreign	83,722	423,022	363,173
	\$ 237,672	\$ 586,109	\$ 396,193

i. 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:



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	Year ended December 31,		
	2005	2004	2003
Loss from continuing operations before taxes, as reported in the consolidated statements of income	<u>\$(23,742,888)</u>	<u>\$(8,411,510)</u>	<u>\$(9,108,738)</u>
Statutory tax rate	<u>34%</u>	<u>34%</u>	<u>34%</u>
Theoretical income tax on the above amount at the U.S. statutory tax rate	<u>\$(8,072,582)</u>	<u>\$(2,859,914)</u>	<u>\$(3,096,971)</u>
Deferred taxes on losses for which valuation allowance was provided	1,611,971	556,692	1,146,754
Non-deductible expenses	5,669,144	1,629,874	1,873,129
State taxes	67,470	168,081	33,020
Accrual for deferred taxes on undistributed earnings	(49,328)	49,416	—
Foreign income in tax rates other than U.S rate	897,617	919,895	86,954
Taxes in respect of prior years	139,963	84,292	352,091
Others	(26,583)	37,773	1,216
Actual tax expense	<u>\$ 237,672</u>	<u>\$ 586,109</u>	<u>\$ 396,193</u>

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

Financial income (expenses), net:

	Year ended December 31,		
	2005	2004	2003
Financial expenses:			
Interest, bank charges and fees	\$ (1,473,799)	\$ (622,638)	\$ (355,111)
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature	(1,702,753)	(4,142,109)	(3,928,237)
Bonds premium amortization	(47,734)	(202,467)	—
Foreign currency translation differences	(54,840)	(71,891)	115,538
	<u>(3,279,126)</u>	<u>(5,039,105)</u>	<u>(4,167,810)</u>
Financial income:			
Interest	192,771	443,182	129,101
Realized gain from marketable securities sale	2,863	40,119	—
Financial income in connection with warrants granted (Note 12.d. and 13.f.3.)	377,803	326,839	—
Total	<u>\$ (2,705,689)</u>	<u>\$ (4,228,965)</u>	<u>\$ (4,038,709)</u>

**NOTE 16:– 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 Training (formerly known as 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:



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	Simulation and Training	Armor	Battery and Power Systems	All Others(4)	Total
<b>2005</b>					
Revenues from outside customers	\$26,805,772	\$12,322,678	\$ 9,916,145	\$ —	\$49,044,595
Depreciation expenses and amortization <sup>(1)</sup>	(1,645,057)	(14,043,019)	(909,463)	(229,626)	(16,827,165)
Direct expenses <sup>(2)</sup>	(21,967,755)	(13,955,199)	(9,757,402)	(7,752,865)	(53,433,221)
Segment net income (loss)	<u>\$ 3,192,960</u>	<u>\$ (15,675,540)</u>	<u>\$ (750,720)</u>	<u>\$ (7,982,491)</u>	<u>(21,215,791)</u>
Financial expenses (after deduction of minority interest)					(2,707,620)
Net loss from continuing operations					<u>\$(23,923,411)</u>
Segment assets <sup>(3)</sup>	<u>\$32,741,946</u>	<u>\$ 7,185,010</u>	<u>\$12,040,415</u>	<u>\$ 688,023</u>	<u>\$52,655,394</u>
<b>2004</b>					
Revenues from outside customers	\$21,464,406	\$17,988,687	\$10,500,753	\$ —	\$49,953,846
Depreciation expenses and amortization <sup>(1)</sup>	(1,983,822)	(1,755,847)	(1,132,953)	(135,613)	(5,008,235)
Direct expenses <sup>(2)</sup>	(17,910,967)	(16,444,476)	(9,974,544)	(5,431,627)	(49,761,614)
Segment net income (loss)	<u>\$ 1,569,617</u>	<u>\$ (211,636)</u>	<u>\$ (606,744)</u>	<u>\$ (5,567,240)</u>	<u>(4,816,003)</u>
Financial expenses (after deduction of minority interest)					(4,226,310)
Net loss from continuing operations					<u>\$(9,042,313)</u>
Segment assets <sup>(3)</sup>	<u>\$ 1,872,943</u>	<u>\$ 5,819,266</u>	<u>\$ 3,455,188</u>	<u>\$ 730,595</u>	<u>\$11,877,992</u>
<b>2003</b>					
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 <sup>(2)</sup>	(7,308,649)	(3,584,284)	(5,945,948)	(4,200,770)	(21,039,651)
Segment net income (loss)	<u>\$ (44,620)</u>	<u>\$ (318,236)</u>	<u>\$ (604,824)</u>	<u>\$ (4,340,400)</u>	<u>(5,308,080)</u>
Financial expenses (after deduction of minority interest)					(4,039,951)
Net loss from continuing operations					<u>\$(9,348,031)</u>
Segment assets <sup>(3)</sup>	<u>\$ 898,271</u>	<u>\$ 730,291</u>	<u>\$ 2,128,062</u>	<u>\$ 450,864</u>	<u>\$ 4,207,488</u>

<sup>(1)</sup> Includes depreciation of property and equipment, amortization expenses of intangible assets and impairment of goodwill and other intangible assets in the amount of \$12,256,756 and \$320,279 in the years 2005 and 2004, respectively.

<sup>(2)</sup> Including, *inter alia*, sales and marketing, general and administrative and tax expenses.

<sup>(3)</sup> Consisting of property and equipment, inventory and intangible assets.

<sup>(4)</sup> Out of those amounts, goodwill in the Company's Simulation and Training, Battery and Power Systems and Armor Divisions stood at \$23,605,069, \$4,968,675 and \$985,413 as of December 31, 2005, respectively, and \$22,845,372, \$5,308,917 and \$11,591,227 as of December 31, 2004, respectively.

c. Summary information about geographic areas:

The following presents total revenues according to end customers location for the years ended December 31, 2005, 2004 and 2003, and long-lived assets as of December 31, 2005, 2004 and 2003:

	2005		2004		2003	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars					
U.S.A.	\$38,953,462	\$32,840,172	\$40,656,729	\$45,154,086	\$10,099,652	\$ 6,778,050
Germany	188,635	—	319,110	—	2,836,725	—
England	931,008	—	344,261	—	29,095	—
Thailand	—	—	—	—	95,434	—
India	1,723,031	—	3,061,705	—	—	—
Israel	5,700,267	11,999,415	4,212,408	13,560,822	3,576,139	2,954,441
Other	1,548,192	—	1,359,633	—	689,596	—
	<u>\$49,044,595</u>	<u>\$44,839,587</u>	<u>\$49,953,846</u>	<u>\$ 58,714,908</u>	<u>\$17,326,641</u>	<u>\$ 9,732,491</u>



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. Dollars

d. Revenues from major customers:

	Year ended December 31,		
	2005	2004	2003
	%		
Batteries and power systems:			
Customer A	7%	8%	27%
Armor:			
Customer B	5%	4%	17%
Customer C	9%	24%	—
Simulation and training:			
Customer D	24%	13%	—
Customer E	—	1%	16%

e. Revenues from major products:

	Year ended December 31,		
	2005	2004	2003
Electric vehicle	\$ 205,485	\$ 232,394	\$ 408,161
Water activated batteries	1,181,114	921,533	703,084
Military batteries	8,515,329	9,324,247	4,757,116
Car armoring	12,322,679	17,988,686	3,435,715
Simulators	26,785,772	21,414,968	7,961,302
Other	34,216	72,018	61,263
Total	<u>\$49,044,595</u>	<u>\$49,953,846</u>	<u>\$17,326,641</u>

**NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED)**

a. In March 2006, a dispute of approximately \$517,000 related to the Company's former consumer cell-phone battery and charger business between the Company and a major department store chain, in respect of which dispute the Company had made an accrual of \$200,000 in the past, was settled for a single payment by the Company of \$120,000 in cash. The Company's liability accrual was updated to reflect this settlement agreement.

b. In March 2006, a dispute that began in 2005 involving a claim against the Company in the amount of approximately \$1.1 million was settled for an aggregate payment by the Company of \$90,000 in cash, \$60,000 of which was payable in 2006 and \$30,000 of which was payable in 2007. The Company accrued \$90,000 to reflect this settlement agreement.

c. In February 2006, the Company and one of its existing warrant holders agreed to amend certain of the investor's existing warrants (consisting of 363,300 warrants to purchase common stock at a price of \$2.20 per share and 4,514,367 warrants to purchase common stock at a price of \$1.38 per share – a total of 4,877,667 warrants) to provide for an exercise price equal to \$0.44034, in exchange for (i) immediate exercise by the investor of all such warrants, with the exercise price being deposited in a collateral account to secure the Company's obligation to repay its 8% secured convertible debentures due in September 2006, and (ii) the issuance to the investor of 1,951,067 warrants, expiring on March 31, 2008, with an exercise price equal to \$0.594 per share.

d. In March 2006, the Company and certain of its existing warrant holders ("Investors") agreed to amend certain of the Investors' existing warrants (consisting of 415,200 warrants to purchase common stock at a price of \$2.20 per share, 797,872 warrants to purchase common stock at a price of \$1.88 per share, 274,748 warrants to purchase common stock at a price of \$1.45 per share, 125,000 warrants to purchase common stock at a price of \$1.4375 per share, and 2,502,658 warrants to purchase common stock at a price of \$1.38 per share – a total of 4,115,478 warrants) to provide for an exercise price equal to \$0.40, in exchange for (i) immediate exercise by the Investors of all such warrants, with the exercise price being deposited in a collateral account to secure the Company's obligation to repay its 8% secured convertible debentures due in September 2006, and (ii) the issuance to the Investors of a total of 1,646,192 warrants, expiring on March 31, 2008, with an exercise price equal to \$0.594 per share.

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## SUPPLEMENTARY FINANCIAL DATA

### Quarterly Financial Data (unaudited) for the two years ended December 31, 2005

2005	Quarter Ended*			
	March 31	June 30	September 30	December 31
Net revenue.....	\$ 10,387,445	\$ 12,236,910	\$ 11,189,675	\$ 15,230,565
Gross profit.....	\$ 4,015,570	\$ 3,627,634	\$ 2,756,392	\$ 4,261,263
Net profit (loss) from continuing operations				
	\$ (2,456,500)	\$ (5,422,514)	\$ (12,708,932)	\$ (3,335,465)
Net loss from discontinued operations .....	\$ —	\$ (200,000)	\$ —	\$ 80,000
Net profit (loss) for the period .....	\$ (2,456,500)	\$ (5,622,514)	\$ (12,708,932)	\$ (3,255,465)
Deemed dividend to certain stockholders of common stock				
	\$ —	\$ —	\$ —	\$ —
Net loss attributable to common stockholders..	\$(2,456,500)	\$(5,622,514)	\$(12,708,932)	\$(3,255,465)
Net profit (loss) per share – basic and diluted...	\$ (0.03)	\$ (0.07)	\$ (0.15)	\$ (0.04)
Shares used in per share calculation .....	80,102,089	80,780,149	82,475,778	85,446,876

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



## FINANCIAL STATEMENT SCHEDULE

### Arotech Corporation and Subsidiaries

#### Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2005, 2004 and 2003

Description	Balance at beginning of period	Additions charged to costs and expenses	Balance at end of period
<b>Year ended December 31, 2005</b>			
Allowance for doubtful accounts.....	\$ 55,394	\$ 120,786	\$ 176,180
Allowance for slow moving inventory	217,672	1,062,336	1,280,008
Valuation allowance for deferred taxes.....	33,725,995	757,801	34,483,796
<b>Totals.....</b>	<b>\$ 33,999,061</b>	<b>\$ 1,940,923</b>	<b>\$ 35,939,984</b>
<b>Year ended December 31, 2004</b>			
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
<b>Totals.....</b>	<b>\$ 34,959,519</b>	<b>\$ (960,458)</b>	<b>\$ 33,999,061</b>
<b>Year ended December 31, 2003</b>			
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
<b>Totals.....</b>	<b>\$ 29,600,958</b>	<b>\$ 5,358,561</b>	<b>\$ 34,959,519</b>



## **AROTECH DIRECTORS**

Robert S. Ehrlich, Director  
*Chairman 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  
*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.*

Prof. Seymour Jones, Director  
*Clinical Professor of Accounting,  
New York University Stern School of Business*

## **AROTECH CORPORATE OFFICERS**

Robert S. Ehrlich  
*Chairman and Chief Executive Officer*

Steven Esses  
*President and Chief Operating Officer*

Dean Krutty  
*President, Simulation and Training Division*

Jonathan Whartman  
*President, Armor Division*

Dr. Neal Naimer  
*President, Battery Division*

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

Thomas J. Paup  
*Vice President – Finance and CFO*

Kim Kelly  
*Vice President – Corporate Communications*

Danny Waldner  
*Controller*

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## **STOCKHOLDER INFORMATION**

### **Annual Meeting**

The annual meeting of stockholders will be held on Monday, June 19, 2006, at 10:00 a.m. local time in the Lexington Room of the Shelburne Murray Hill Hotel, 303 Lexington Avenue, New York, New York.

### **Stock Transfer Agent**

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

### **Shares Traded**

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

### **Forms 10-K**

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

### **Website**

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

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**AROTECH**

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