

AROTECH

LEADING PRODUCTS FOR MILITARY, HOMELAND SECURITY,
LAW ENFORCEMENT AND PUBLIC SAFETY REQUIREMENTS

Arotech Corporation

Annual Report 2007

Nasdaq: ARTX



**WE TRAIN
WE PROTECT
WE SUPPLY**



**Training & Simulation
Division**

Armor Division



**Battery & Power
Systems Division**



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The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on April 14, 2008.

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

General

We are a defense and security 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 commercial markets; and batteries and charging systems for the military. We operate primarily through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned by us) 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 **Training and Simulation 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, located in Ann Arbor, Michigan, which we merged into our FAAC subsidiary in October of 2007 ("IES").

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

- 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"), and MDT Armor Corporation, located in Auburn, Alabama ("MDT Armor"); and
- We provide ballistic armor kits for rotary and fixed wing aircraft and marine armor through our subsidiary

Armour of America, located in Auburn, Alabama ("AoA").

➤ We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications 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 develop, manufacture and market primary Zinc-Air batteries, rechargeable batteries and battery chargers for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama ("EFB"); and
- We produce water-activated life-jacket lights for commercial aviation and marine applications through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel ("EFL").

Background

We were incorporated in Delaware in 1990 under the name "Electric Fuel Corporation," and we changed our name to "Arotech Corporation" on September 17, 2003. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech's wholly-owned Israeli subsidiaries, EFL, Epsilor and MDT; and Arotech's wholly-owned United States subsidiaries, EFB, IES, FAAC, AoA and MDT Armor.

For financial information concerning the business segments in which we operate, see Note 16.b. of the Notes to the Consolidated Financial Statements. For financial information about geographic areas in which we engage in business, see Note 16.c. of the Notes to the Consolidated Financial Statements.

Facilities

Our principal executive offices are located at 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our 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; our financial operations are conducted primarily from our principal executive offices in Ann Arbor. IES's and FAAC's home offices and facilities are located in Ann Arbor, Michigan, and the offices and facilities of EFB, MDT Armor and AoA are located in Auburn, Alabama.

Training and Simulation Division

We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driver training of military, law enforcement, security and other personnel through our Training and Simulation Division, the largest of our three divisions. During 2007 and 2006, revenues from our Training and Simulation Division were approximately \$27.8 million and \$22.0 million, respectively.

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

- Our *Vehicle Simulation* group provides high fidelity vehicle simulators for use in operator training and is marketed under our FAAC nameplate;
- Our *Military Operations* group provides weapon simulations used to train military pilots in the effective use of air launched weapons and is also marketed under our FAAC nameplate; and

- Our *Use of Force* group provides training products focused on the proper employment of hand carried weapons and is marketed under our IES Interactive Training nameplate.

Vehicle Simulation

We provide simulators, systems engineering and software products focused on training vehicle operators for cars and trucks. We provide these products to the United States military, government, municipalities, and private industry through our FAAC nameplate. Our fully interactive driver-training systems feature state-of-the-art vehicle simulator technology enabling training in situation awareness, risk analysis and decision making, emergency reaction and avoidance procedures, and proper equipment operation techniques. Our simulators have successfully trained hundreds of thousands of drivers.

Our Vehicle Simulation group focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, subway trains, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles. In 2007, our Vehicle Simulations group accounted for approximately 55% of our Training and Simulation Division's revenues.

We believe that we have held near a 100% market share in U.S. military wheeled vehicle operator driver training simulators since 1999 and that we are currently one of three significant participants in the U.S. municipal wheeled vehicle simulators market.

Military Operations

In the area of Military Operations, we believe we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare systems for all branches of the Department of Defense and its related industrial contractors. Our simulations are found in systems ranging from instrumented air combat and maneuver training ranges (such as Top Gun), full task training devices such as the F-18 Weapon Tactics Trainer, and in the on-board computer of many fighter jet aircraft. In 2007, our Military Operations group accounted for 20% of our Training and Simulation Division's revenues.

FAAC is the sole provider of validated weapon simulations used in US air-combat training. We supply on-board software to support weapon launch decisions for the F-15, F-16, F-18, and Joint Strike Fighter (JSF) fighter aircraft.

We also provide an instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system.

Use-of-Force

We are a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, security, military and similar applications. With a large customer base spread over twenty countries around the world, we are a leader in the supply of simulation training products to law enforcement, governmental, and commercial clients. We conduct our interactive training activities using our IES Interactive Training nameplate. In 2007, our Use of Force group accounted for 25% of our Training and Simulation Division's revenues.

Marketing and Customers

We market our Simulation Division products to all branches of the U.S. military, federal and local government, municipal transportation departments, and public safety groups. Municipalities throughout the U.S. are using our vehicle simulators and use-of-force products, and our penetration in Asia, Europe and the Americas continues through the use of commissioned sales agents and regional distributors.

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

Competition

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

VEHICLE SIMULATORS

Several potential competitors in this segment are large, diversified defense and aerospace conglomerates who do not focus on our specific niches. As such, we are able to provide service on certain large military contracts through strategic agreements with these organizations or can compete directly with these organizations based on our strength in developing

higher quality software solutions. In municipal market applications, we compete against smaller, less sophisticated software companies. Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

MILITARY OPERATIONS

Currently no significant competitors participate in the markets we serve around our weapon simulation niche. Our 30-year history in this space provides a library of resources that would require a competitor to invest heavily in to offer a comparable product. The companies that could logically compete with us if they chose would be the companies that now subcontract this work to us: Boeing, Raytheon and Cubic.

USE OF FORCE

We compete against a number of established companies that provide similar products and services, many of which have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours. There are also companies whose products do not compete directly, but are sometimes closely related. Firearms Training Systems, Inc., Advanced Interactive Systems, Inc., and LaserShot Inc. are our main competitors in this space.

Armor Division

We armor vehicles and manufacture aviation and other armor through our Armor Division. During 2007 and 2006, revenues from our Armor Division were approximately \$18.7 million and \$12.6 million, respectively.

Introduction

We specialize in armoring vehicles and manufacturing armor kits for aircraft and vessels by using state-of-the-art lightweight ballistic materials, special ballistic glass and advanced engineering processes. We fully armor vehicles, vans, SUVs and small buses. We also provide ballistic armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, and armor for architectural applications.

We operate through three business units: MDT Protective Industries Ltd., located in Lod, Israel (in which we acquired a majority stake in 2002), MDT Armor Corporation, which we established in 2003 in Auburn, Alabama and Armour of

America, which we acquired in 2004 and relocated to Auburn, Alabama.

We are a leading supplier to the Israeli military, Israeli Special Forces and special services. We provide products to the US Army, and to military and defense and paramilitary customers worldwide.

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.

During 2006 and 2007, we received over \$26 million in orders from the Israel Defense Forces for the U.S.-built David, a patrol, combat command and reconnaissance armored vehicle that is specifically designed as an urban combat vehicle.

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

Sales, Marketing and Customers

Most of our vehicle armoring business has historically come from Israel, although we have armored vehicles under contracts for companies operating in Iraq. Our principal customer at present is the Israeli Ministry of Defense. Other customers include Israeli and American government ministries and agencies, private companies, medical services and private clients. In the United States, we have armored vehicles for U.S. operations in Iraq.

In Israel, we market our vehicle armoring through vehicle importers, both pursuant to marketing agreements and otherwise, and directly to private customers in the public and private sectors. Most sales are through vehicle importers. In the U.S., vehicles are sold to the Army.

Our commercial aircraft customers have included Bell Helicopter, MD Helicopter, Robinson Helicopter, Sikorsky Helicopter, Schweitzer Helicopter, Agusta, and Lockheed-Martin in the United States, as well as Eurocopter (Germany), Alenia Aerospazio (Italy), EADS (Spain), and Bell (Canada).

Our U.S. military aircraft customers have included NAVSEA, NAVAIR, Army, Coast Guard, Marines, State Department, Border Patrol, and various SEAL and Small Boat Units.

Our foreign military customers have included the air forces of New Zealand, Australia, Thailand, Malaysia, Spain, Belgium, Sweden, Norway, Italy, Sri Lanka, Indonesia, Brazil, Argentina, and Turkey; the navies of Singapore, Thailand, Malaysia, Ecuador, Mexico, Colombia, Spain, Australia, and Japan; the armies of Thailand, Malaysia, Sri Lanka, Colombia, Mexico, Ecuador, Venezuela and Peru.

Manufacturing

Our manufacturing facilities are located in Lod, Israel, and in Auburn, Alabama. In Israel we manufacture armored vehicles only, and in the US we manufacture vehicle armoring, and hard and soft armor.

Our facilities have been awarded ISO 9001:2000 quality standards certification.

Competition

The global armored car industry is highly fragmented. Major suppliers include both vehicle manufacturers and aftermarket specialists. As a highly labor-intensive process, vehicle armoring is numerically dominated by relatively small businesses. Industry estimates place the number of companies doing vehicle armoring in the range of around 500 suppliers globally. While certain large companies may armor several hundred cars annually, most of these companies are smaller operations that may armor in the range of five to fifty cars per year.

Among vehicle manufacturers, we believe Mercedes-Benz to have the largest vehicle-armoring market share. Among aftermarket specialists, we believe the largest share of the vehicle-armoring market is held by O'Gara-Hess & Eisenhardt, a subsidiary of Armor Holdings, Inc. Other aftermarket specialists include International Armoring Corp., Lasco, Texas Armoring and Chicago Armor (Moloney). Many of these companies have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

We believe the key factor in our competing successfully in this field will be our ability to penetrate new military and paramilitary markets outside of Israel, particularly those operating in Iraq and Afghanistan.

Battery and Power Systems Division

We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications through our Battery and Power Systems Division. During 2007 and 2006, revenues from our Battery and Power Systems Division were approximately \$11.2 million and \$8.6 million, respectively.

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

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

We specialize in the design and manufacture of primary and rechargeable batteries, related electronic circuits and associated chargers for military applications. We have experience in working with government agencies, the military and large corporations. Our technical team has significant expertise in the fields of electrochemistry, electronics, software and battery design, production, packaging and testing.

We have added lithium-ion battery production capabilities at EFB's facility in Auburn. The goal is to enable U.S.-produced lithium-ion batteries and chargers to be sold using funding from Foreign Military Funding (FMF) program to countries such as Israel and Turkey. These products are marketed and designed by Epsilor and manufactured by EFB.

COMPETITION

The main competitors for our lithium-ion battery products are Bren-tronics Inc. in the United States, which controls much of the U.S. rechargeable market, AEA Battery Systems (a wholly owned subsidiary of AEA Technology plc) in the United Kingdom, which has the majority of the English military market, and Ultralife Batteries, Inc. in the United States. On the primary end of the market there are a host of players who include the cell manufacturers themselves, including Saft S.A. and Ultralife Batteries, Inc.

It should be noted that a number of OEMs, such as Motorola, have internal engineering groups that can develop competitive products in-house. Additionally, many of our competitors have financial, technical, marketing, sales,

manufacturing, distribution and other resources significantly greater than ours.

MARKETING

We market to our existing customers through direct sales. To generate new customers and applications, we rely on our working relationship with a selection of OEMs, with the intent of having these OEMs design our products into their equipment, thereby creating a market with a high entry barrier. Another avenue for market entry is via strategic relationships with major cell manufacturers.

MANUFACTURING

Our battery production lines for military batteries and chargers have been ISO-9001 certified since 1994. We believe that Epsilor's 19,000 square foot facility in Dimona, Israel has the necessary capabilities and operations to support our production cycle.

Zinc-Air 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 battery technology, as applied in the batteries we produce for the U.S. Army's Communications and Electronics Command (CECOM) through our subsidiary EFB. 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.

Our batteries have been used in both Afghanistan (Operation Enduring Freedom) and in Iraq (Operation Iraqi Freedom). In June of 2004, our BA-8180/U 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 EFB. In 2003, EFB's facilities were granted ISO 9001 "Top Quality Standard" certification.

MARKETS/APPLICATIONS

As an external alternative to the popular lithium based BA-5590/U, the BA-8180/U can be used in many applications operated by the BA-5590/U. The BA-8180/U can be used for a variety of military applications.

CUSTOMERS

The principal customers for our Zinc-Air batteries during 2007 were the U.S. Army's Communications-Electronics Command (CECOM) and the Defense Logistics Agency (DLA). In addition, we continue to further penetrate Special Forces and other specific U.S. military units with direct sales.

COMPETITION

The BA-8180/U is the only Zinc-Air battery to hold a US Army battery designation and an NSN. It does, however, compete with other primary (disposable) batteries, and primarily lithium based batteries. In some cases it will also compete with rechargeable batteries.

Zinc-Air batteries are inherently safer than primary lithium battery packs in storage, transportation, use, and disposal, and are more cost-effective. They are lightweight, with up to twice the energy density of primary lithium battery packs. Zinc-Air batteries for the military are also under development by Rayovac Corporation. Rayovac's military Zinc-Air batteries utilize cylindrical cells, rather than the prismatic cells that we developed. While cylindrical cells may provide higher specific power than our prismatic cells, we believe they will generally have lower energy densities and be more difficult to manufacture.

The most popular competing primary battery in use by the US Armed Forces is the BA-5590/U, which uses lithium-sulfur dioxide (LiSO_2) cells. The largest suppliers of LiSO_2 batteries to the US military are believed to be Saft America Inc. and Eagle Picher Technologies LLC. The battery compartment of most military communications equipment, as well as other military equipment, is designed for the XX90 family of batteries, of which the BA-5590/U battery is the most commonly deployed. Another primary battery in this family is the BA-5390/U, which uses lithium-manganese dioxide (LiMnO_2) cells. Suppliers of LiMnO_2 batteries include Ultralife Batteries Inc., Saft and Eagle Picher.

Rechargeable batteries in the XX90 family include lithium-ion (BB-2590/U) and nickel-metal hydride (BB-390/U) batteries which may be used in training missions in order to save the higher costs associated with primary batteries. These rechargeable batteries are also become more prevalent in combat use as their energy densities improve, their availability expands and their State-of-Charge Indicator (SOC) technologies become more reliable.

Our BA-8180/U does not fit inside the XX90 battery compartment of any military equipment, and therefore is connected externally using an interface adapter that we also sell to the Army. Our battery offers greatly extended mission time, along with lower total mission cost, and these significant advantages often greatly outweigh the slight inconvenience of fielding an external battery.

MANUFACTURING

EFL maintains a battery and electronics development and manufacturing facility in Auburn, Alabama, housed in a 30,000-square-foot light industrial space leased from the city of Auburn. We also have production capabilities for some battery components at EFL's facility in Beit Shemesh, Israel. Both of these facilities have received ISO 9001 "Top Quality Standard" certification.

Lifejacket Lights

PRODUCTS

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.

MARKETING

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

COMPETITION

The largest manufacturer of aviation and marine safety products, including TSO and

SOLAS-approved lifejacket lights, is ACR Electronics Inc. of Hollywood, Florida. Other significant competitors in the marine market include Daniamant Aps of Denmark and England, and SIC of Italy.

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, 2007 and 2006, our backlog for the following years was approximately \$48.7 million and \$41.3 million, respectively, divided among our divisions as follows:

Division	2007	2006
Training and Simulation Division.....	\$ 21,670,000	\$ 11,518,000
Battery and Power Systems Division...	12,861,000	9,213,000
Armor Division	14,164,000	20,582,000
TOTAL:	\$ 48,695,000	\$ 41,313,000

Major Customers

During 2007 and 2006, including all of our divisions, various branches of the United States military accounted for approximately 52% and 58% of our revenues.

Price Range of Common Stock

Our common stock is traded on the Nasdaq Global Market (formerly known as the

Nasdaq National Market) and, since September 2007, on the Tel-Aviv Stock Exchange (the "TASE"). Our Nasdaq and TASE 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 Global/National Market System; such prices have been adjusted to reflect the one-for-fourteen reverse stock split effected on June 21, 2006:

<u>Year Ended December 31, 2007</u>	<u>High</u>	<u>Low</u>
Fourth Quarter	\$ 3.63	\$ 1.94
Third Quarter	\$ 3.70	\$ 2.52
Second Quarter.....	\$ 3.73	\$ 2.15
First Quarter.....	\$ 4.87	\$ 3.03
<u>Year Ended December 31, 2006</u>	<u>High</u>	<u>Low</u>
Fourth Quarter	\$ 3.69	\$ 1.43
Third Quarter	\$ 3.92	\$ 1.88
Second Quarter.....	\$ 8.12	\$ 2.25
First Quarter.....	\$ 8.96	\$ 5.18

As of February 29, 2008 we had approximately 327 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.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve inherent risks and uncertainties. When used in this discussion, the words "believes," "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 the "Risk Factors" section in our filings with the Securities and Exchange Commission.

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements contained in Item 8 of 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 ***Training and Simulation Division***);
- we provide aviation armor kits and we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our ***Armoring Division***); and
- we develop, manufacture and market primary Zinc-Air batteries, rechargeable batteries and battery chargers for defense and security products and other military applications (our ***Battery and Power Systems Division***).

Critical Accounting Policies

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

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

Revenue Recognition

Significant management judgments and estimates must be made and used in connection with

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

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

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

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

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

Stock Based Compensation

We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R) ("SFAS No. 123(R)"), "Share-Based Payment," using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

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. We 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. We do not provide for U.S. federal income taxes on the undistributed earnings of our foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

On January 1, 2007, we adopted the provisions of the Financial Accounting Standards Board Interpretation No.48, Accounting for Uncertainty in Income Taxes ("FIN 48"), an interpretation of Statement 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. We must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a posi-

tion meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. FIN 48 applies to all tax positions related to income taxes subject to Statement 109. Uncertain tax positions require determinations and estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If our determinations and estimates prove to be inaccurate, the resulting adjustments could be material to its future financial results. Based on the analysis performed, we did not record any unrecognized tax positions as of December 31, 2007.

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

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2007, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

Under Financial Accounting Standards Board Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual im-

pairment tests based on estimated fair value in accordance with SFAS 142.

We determine fair value using a 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.

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 Epsilon is in New Israel Shekels ("NIS") and a substantial portion of MDT's and Epsilon's costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT and Epsilon. Accordingly, the financial statements of MDT and Epsilon 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 stockholders' equity.

Recent Developments

Purchase of the Minority Interest in MDT Israel and MDT Armor

In January 2008, we purchased the minority shareholder's 24.5% interest in MDT Israel and

the 12.0% interest in MDT Armor, as well as settling all outstanding disputes regarding severance payments, in exchange for a total of \$1.0 million. We are currently evaluating the impact of this transaction on our first quarter 2008 financial statements.

Purchase of Realtime Technologies, Inc.

In February 2008 our FAAC subsidiary acquired Realtime Technologies, Inc. (RTI), a privately-owned corporation headquartered in Royal Oak, Michigan, close to the headquarters of the rest of our Training and Simulation Division, for a total of \$1,350,000 (\$1,250,000 in cash and \$100,000 in stock) with a 2008 earn-out (maximum of \$250,000) based on 2008 net profit. Since its founding in 1998, RTI has specialized in multi-body vehicle dynamics modeling and graphical simulation solutions. RTI offers simulation software applications, consulting services, custom engineering solutions, and software and hardware development.

AoA Arbitration

In connection with our acquisition of AoA, we had a contingent earnout obligation in an amount equal to the revenues AoA realized from certain specific programs that were identified by us and the seller of AoA ("Seller") as appropriate targets for revenue increases. As of December 31, 2006, we had reduced the \$3.0 million escrow held by the Seller by \$1,520,174 for a putative claim against such escrow in respect of such earn-out obligation.

On March 20, 2007, we filed a Demand for Arbitration with the American Arbitration Association against the Seller. In our demand, we sought the return of \$3.0 million, plus interest, held in escrow by the Seller in connection with his sale of AoA to us in 2004. The Seller asserted counterclaims against us in the arbitration, alleging (i) that he is entitled to keep the \$3.0 million, (ii) that he is entitled to an additional \$3.0 million in post-sale earnouts, and (iii) that he is entitled to \$70,000 in compensation (plus interest and statutory penalties) wrongfully withheld by us when we constructively terminated his employment.

In February 2008, the arbitration panel issued a decision denying the Seller's counterclaims (i) and (ii) above, granting the Seller's counterclaim for \$70,000 in compensation, awarding us the entire \$3.0 million escrow (less the \$70,000 in compensation (with simple interest but without statutory penalties)), and awarding us \$135,000 in

attorneys' fees. The time for the Seller to move to vacate or modify this award has not yet expired.

Executive Summary

Overview of Results of Operations

We incurred significant operating losses for the years ended December 31, 2007 and 2006. 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.

A portion of our operating loss during 2007 and 2006 arose as a result of non-cash charges. These charges were primarily related to our acquisitions, financings and issuances of restricted shares and options to employees. To the extent that we continue certain of these activities during 2008, we would 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 continued during 2007. 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 2007 and 2006 in the amount of \$1.4 million and \$1.9 million, respectively.

FINANCINGS AND ISSUANCES OF RESTRICTED SHARES, OPTIONS AND WARRANTS

The non-cash charges that relate to our financings occurred in connection with our issuance of convertible securities with warrants, and in connection with our repricing of certain warrants and grants of new warrants. When we issue convertible securities, 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 securities, we record debt discount for financial expenses that is amortized ratably over the term of the convertible securities; when the convertible securities are converted, the entire remaining unamortized debt discount is immediately recognized in the quarter in which the convertible securities are converted.

During 2007 and 2006, we issued restricted shares to certain of our employees. These shares were issued as stock bonuses, and are restricted for a period of up to three 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 2007 and 2006 in the amount of \$1,332,000 and \$360,000, respectively.

As a result of options granted to employees and the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payments," we incurred non-cash charges related to stock-based compensation in 2007 and 2006 in the amount of \$86,000 and \$141,000, respectively.

As part of the repricings and exercises of warrants described in Note 13 of the Notes to Consolidated Financial Statements, we issued warrants to purchase up to 298,221 shares of common stock. Since the terms of these warrants provided that the warrants were exercisable subject to our obtaining stockholder approval, in ac-

cordance 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 until we obtained stockholder approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the stockholder approval) using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$700,000 has been recorded as finance income.

Under the terms of our convertible notes, which have been paid in full, we had the option in respect of scheduled principal repayments to force conversion of the payment amount at a conversion price based upon the weighted average trading price of our common stock during the 20 trading days prior to the conversion, less a discount of 8%.

On April 7, 2006, we and each holder of our convertible notes agreed that we would force immediate conversion of an aggregate of \$6,148,904 principal amount of the convertible notes into 1,098,019 shares of our common stock. The amount converted eliminated our obligation to make the installment payments under the convertible notes on each of March 31, 2008, January 31, 2008, November 30, 2007 and September 30, 2007 (aggregating a total of \$5,833,333). In addition, as a result of the conversion an additional \$315,570 was applied against part of the installment payment due July 31, 2007. After giving effect to the conversion, \$8,434,430 of principal remained outstanding under the convertible notes.

During the remainder of 2006, we converted \$1,458,333 of principal remaining outstanding under our convertible notes by forcing conversion of this principal amount into 526,444 shares of our common stock. During 2007, we converted the remaining \$6,976,097 of principal remaining outstanding under our convertible notes by forcing conversion of this principal amount into 930,125 shares of our common stock.

Additionally, in an effort to improve our cash situation and our shareholders' equity, we have periodically induced holders of certain of our war-

rants to exercise their warrants by lowering the exercise price of the warrants in exchange for immediate exercise of such warrants, and by issuing to such investors new warrants. Under such circumstances, we record a deemed dividend in an amount determined based upon the fair value of the new warrants (using the Black-Scholes pricing model). As and to the extent that we engage in similar warrant repricings and issuances in the future, we would incur similar non-cash charges.

During 2007 and 2006, the Company recorded expenses of \$19,000 and \$1.5 million, respectively, attributable to amortization related to warrants issued to the holders of convertible debentures and the beneficial conversion feature. During 2007 and 2006, the Company also recorded expenses of \$280,000 and \$5.4 million, respectively, attributable to financial expenses in connection with convertible debenture principle repayment. Additionally, during 2007 and 2006, the Company recorded expenses of \$44,000 and \$781,000, respectively, attributable to amortization of deferred charges related to convertible debentures issuance that were recorded as a general and administrative expense.

Overview of Operating Performance and Backlog

Overall, our net loss before minority interest earnings, earnings from an affiliated company and tax expenses for 2007 was \$2.8 million on revenues of \$57.7 million, compared to a net loss of \$15.7 million on revenues of \$43.1 million during 2006. As of December 31, 2007, our overall backlog totaled \$48.7 million.

In our Training and Simulation Division, revenues increased from approximately \$22.0 million in 2006 to \$27.8 million in 2007. As of December 31, 2007, our backlog for our Training and Simulation Division totaled \$21.7 million.

In our Battery and Power Systems Division, revenues increased from approximately \$8.6 million in 2006 to approximately \$11.2 million in 2007. As of December 31, 2007, our backlog for our Battery and Power Systems Division totaled \$12.9 million.

In our Armor Division, revenues increased from approximately \$12.6 million in 2006 to approximately \$18.7 million in 2007. As of December 31, 2007, our backlog for our Armor Division totaled \$14.1 million.

Results of Operations

Preliminary Note

SUMMARY

Following is a table summarizing our results of operations for the years ended December 31, 2007 and 2006, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2007	2006
Revenues:		
Training and Simulation Division	\$ 27,760,858	\$ 21,951,337
Armor Division.....	18,724,107	12,571,779
Battery and Power Systems Division.....	11,234,596	8,597,623
	<u>\$ 57,719,561</u>	<u>\$ 43,120,739</u>
Cost of revenues:		
Training and Simulation Division	\$ 15,528,023	\$ 14,196,298
Armor Division.....	15,906,071	12,299,756
Battery and Power Systems Division.....	8,205,718	5,997,592
	<u>\$ 39,639,812</u>	<u>\$ 32,493,646</u>
Research and development expenses:		
Training and Simulation Division	\$ 629,430	\$ 308,738
Armor Division.....	115,500	20,546
Battery and Power Systems Division.....	1,132,233	1,272,170
	<u>\$ 1,877,163</u>	<u>\$ 1,601,454</u>
Sales and marketing expenses:		
Training and Simulation Division	\$ 2,956,995	\$ 2,514,981
Armor Division.....	634,237	366,923
Battery and Power Systems Division.....	570,768	656,604
All Other.....	2,464	175,814
	<u>\$ 4,164,464</u>	<u>\$ 3,714,322</u>
General and administrative expenses:		
Training and Simulation Division	\$ 3,400,013	\$ 2,562,868
Armor Division.....	1,295,079	1,031,333
Battery and Power Systems Division.....	1,658,968	994,136
All Other.....	6,804,237	7,104,479
	<u>\$ 13,158,297</u>	<u>\$ 11,692,816</u>
Other income:		
Training and Simulation Division	\$ 122,934	\$ 361,560
Armor Division.....	152,206	—
All Other.....	342,812	—
	<u>\$ 617,952</u>	<u>\$ 361,560</u>
Financial expense (income):		
Training and Simulation Division	\$ 14,610	\$ (129,908)
Armor Division.....	93,292	54,476
Battery and Power Systems Division.....	176,834	(50,590)
All Other.....	621,152	7,645,922
	<u>\$ 905,888</u>	<u>\$ 7,519,900</u>
Tax expenses (credits):		
Training and Simulation Division	\$ 69,930	\$ 49,383
Armor Division.....	2,639	—
Battery and Power Systems Division.....	(28,653)	182,776
All Other.....	120,000	—
	<u>\$ 163,916</u>	<u>\$ 232,159</u>
Amortization of intangible assets:		
Training and Simulation Division	\$ 776,736	\$ 1,049,136
Armor Division.....	95,907	295,067
Battery and Power Systems Division.....	509,239	509,239
	<u>\$ 1,381,882</u>	<u>\$ 1,853,442</u>
Impairment of goodwill and other intangible assets:		
Armor Division.....	—	316,024
	<u>\$ —</u>	<u>\$ 316,024</u>
Gain (loss) from affiliated company:		
Training and Simulation Division	\$ (40,230)	\$ 354,898
	<u>\$ (40,230)</u>	<u>\$ 354,898</u>
Minority interest in loss (profit) of subsidiaries:		
Armor Division.....	(62,296)	17,407
	<u>\$ (62,296)</u>	<u>\$ 17,407</u>
Net income (loss):		
Training and Simulation Division	\$ 4,467,825	\$ 2,116,299
Armor Division.....	671,292	(1,794,939)
Battery and Power Systems Division.....	(990,511)	(964,304)
All Other.....	(7,205,041)	(14,926,215)
	<u><u>\$ (3,056,435)</u></u>	<u><u>\$ (15,569,159)</u></u>

Fiscal Year 2007 compared to Fiscal Year 2006

Revenues. During 2007, we (through our subsidiaries) recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force 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.
- EFL recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for 2007 totaled \$57.7 million, compared to \$43.1 million in 2006, an increase of \$14.6 million, or 33.9%. This increase was primarily attributable to the following factors:

- Increased revenues from our Training and Simulation Division (\$5.8 million more in 2007 versus 2006).
- Increased revenues from our Battery and Power Systems Division (\$2.6 million more in 2007 versus 2006).
- Increased revenues from our Armor Division (\$6.2 million more in 2007 versus 2006).

In 2007, revenues were \$27.8 million for the Training and Simulation Division (compared to \$22.0 million in 2006, an increase of \$5.8 million, or 26.5%, due primarily to increased sales of military vehicle simulators and use of force simulators); \$11.2 million for the Battery and Power Systems Division (compared to \$8.6 million in 2006, an increase of \$2.6 million, or 30.7%, due primarily to increased sales of our battery products at Epsilon and EFB); and \$18.7 million for the Armor Division (compared to \$12.6 million in 2006, an increase of \$6.2 million, or 48.9%, due primarily to increased revenues from MDT and MDT Armor, mostly in respect of orders for the "David" Armored Vehicle).

Cost of revenues. Cost of revenues totaled \$39.6 million during 2007, compared to \$32.5 million in 2006, an increase of \$7.1 million, or 22.0%, due primarily to increased sales in all divisions, particularly in the production of the "David" Armored Vehicle in our Armor Division, which accounted for over \$2.0 million of the increase. Total cost of revenues and cost of revenues as a percentage of revenue also increased in the Battery and Power Systems Division due to several factors, primarily the production of new products.

Cost of revenues for our three divisions during 2007 were \$15.5 million for the Training and Simulation Division (compared to \$14.2 million in 2006, an increase of \$1.3 million, or 9.4%, due primarily to increased revenues); \$8.2 million for the Battery and Power Systems Division (compared to \$6.0 million in 2006, an increase of \$2.1 million, or 36.8%, due primarily to increased revenues); and \$15.9 million for the Armor Division (compared to \$12.3 million in 2006, an increase of \$3.6 million, or 29.3%, due primarily to production of the "David" Armored Vehicle).

Amortization of intangible assets. Amortization of intangible assets totaled \$1.4 million in 2007, compared to \$1.9 million in 2006, a decrease of \$472,000, or 25.4%, due primarily to completion of the amortization of certain intangible assets at our FAAC and AoA subsidiaries.

Research and development expenses. Research and development expenses for 2007 were \$1.9 million, compared to \$1.6 million during 2006, an increase of \$276,000, or 17.2%, due primarily to an increase in expenses at FAAC for expenses associated with the improvements to our simulator products.

Selling and marketing expenses. Selling and marketing expenses for 2007 were \$4.2 million, compared to \$3.7 million 2006, an increase of \$450,000, or 12.1%. This increase was primarily attributable to the overall increase in revenues and their associated sales and marketing expenses in our Training and Simulation Division and Armor Division, partially offset by a reduction in expense in our Battery and Power Systems Division.

General and administrative expenses. General and administrative expenses for 2007 were \$13.2 million, compared to \$11.7 million in 2006, an increase of \$1.5 million, or 12.5%. This

increase was primarily attributable to additional expenses in all three operating divisions, partially offset by a reduction in corporate expenses.

Financial expenses, net. Financial expenses totaled approximately \$900,000 in 2007 compared to \$7.5 million in 2006, a decrease of \$6.6 million, or 88.0%. The difference was due primarily to decreased interest related to our convertible notes that were issued in September 30, 2006 as a result of payments of principal during 2006, and financial expenses in 2006 related to repayment by forced conversion of our convertible notes at an 8% discount to average market price as provided under the terms of the convertible notes that did not occur to the same extent in 2007.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2007 and, accordingly, no provision for income taxes was recorded for these losses. With respect to some of our subsidiaries that operated at a net profit during 2007, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of \$164,000 in tax expenses in 2007, compared to \$232,000 in tax expenses in 2006, mainly due to state taxes. We also set up a tax liability for the impact of the deductions taken for good will amounted to \$120,000 in 2007. We also adjusted the 2006 accumulated deficit in the amount of \$900,000 to correct the balances in prior years.

Impairment of goodwill and other intangible 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. We performed the required annual impairment test of goodwill, based on our management's projections and using expected future discounted operating cash flows. We did not identify any impairment of goodwill during 2007. In the corresponding period of 2006, we identified in AoA an impairment of goodwill in the amount of \$316,000.

Net loss. Due to the factors cited above, net loss from operations decreased from \$15.6 million in 2006 to \$3.1 million in 2007, an improvement of \$12.7 million, or 81.1%. (Net loss attributable to common stockholders was \$16.0 million in 2006, due to a deemed dividend that was recorded in the amount of \$434,000 in 2006 due to the repricing of existing warrants and the issuance of new warrants.)

Liquidity and Capital Resources

As of December 31, 2007, we had \$3.4 million in cash, \$320,000 in restricted collateral securities, \$1.5 million in an escrow receivable and \$47,000 in available-for-sale marketable securities, as compared to at December 31, 2006, when we had \$2.4 million in cash, \$649,000 in restricted collateral securities, \$1.4 million in an escrow receivable and \$41,000 in available-for-sale marketable securities. We also had \$2.9 million available in unused bank lines of credit, including funds drawn under a \$7.5 million line of credit in favor of our FAAC subsidiary, which line of credit is secured by our assets and the assets of our other subsidiaries and guaranteed by us and our other subsidiaries.

We used available funds in 2007 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets (including the purchase of two buildings in Alabama) by \$2.8 million during the year ended December 31, 2007. Our net fixed assets amounted to \$5.1 million as at year end.

Net cash provided by (used in) operating activities for 2007 and 2006 was \$1.4 million and \$(3.6) million, respectively, an increase of \$5.0 million, due primarily to the reduction of our net loss in 2007, offset in part by an increase in our accounts receivable.

Net cash used in investing activities for 2007 and 2006 was \$1.6 million and \$487,000, respectively. This increase was primarily the result of the purchase of fixed assets along with the payment of promissory notes in respect of an arbitration settlement related to the acquisition of FAAC.

Net cash provided by financing activities for 2007 and 2006 was \$1.1 million and \$452,000, respectively, an increase of \$650,000. This increase was primarily due to changes in debt-related activity.

As of December 31, 2007, we had (based on the contractual amount of the debt and not on the

accounting valuation of the debt, not taking into consideration trade payables, other accounts payables and accrued severance pay) approximately \$4.6 million in bank debt outstanding.

Subject to all of the reservations regarding “forward-looking statements” set forth above, we believe that our present cash position, anticipated cash flows from operations and lines of credit should be sufficient to satisfy our current estimated cash requirements through the remainder of the year. In this connection, we 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.

Over the long term, we will need to become profitable, at least on a cash-flow basis, and maintain that profitability in order to avoid future capital requirements. Additionally, we would need to raise additional capital in order to fund any future acquisitions.

Effective Corporate Tax Rate

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2007 and 2006, and accordingly no provision for income taxes was required. With respect to some of our U.S. subsidiaries that oper-

ated at a net profit during 2007, we were able to offset federal taxes against our net operating loss carryforward, which amounted to approximately \$7.2 million as of December 31, 2007. 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 2007, 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 29% in 2007 (less, in the case of companies that have “approved enterprise” status as discussed in Note 14.b. to the Notes to Financial Statements). We also set up a tax liability for the impact of the deductions taken for goodwill.

As of December 31, 2007, we had a U.S. net operating loss carryforward of approximately \$7.2 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2009 through 2026, and foreign net operating and capital loss carryforwards of approximately \$106 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, 2007, 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	\$ 1,192,342	\$ 103,844	\$ 72,182	\$ 66,215	\$ 950,101
Short-term debt	\$ 4,557,890	\$ 4,557,890	\$ —	\$ —	\$ —
Promissory note due to purchase of subsidiaries	\$ 151,450	\$ 151,450	\$ —	\$ —	\$ —
Operating lease obligations	\$ 4,302,191	\$ 637,760	\$ 997,535	\$ 1,021,224	\$ 1,645,672
Capital lease obligations	\$ 154,532	\$ 67,543	\$ 72,411	\$ 14,578	\$ —
Severance obligations ***	\$ 4,853,231	\$ —	\$ 4,853,231	\$ —	\$ —

* Primarily 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).

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Effective as of June 20, 2006, BDO Seidman, LLP replaced Kost, Forer, Gabbay and Kasserer, a member of Ernst & Young Global, as our independent registered public accounting firm. This change was reported in a Current Re-

port on Form 8-K filed on June 26, 2006. There have been no disagreements with accountants on any matter of accounting principles or financial disclosure required to be reported under this Item.

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2007, 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 con-

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 evaluated the effectiveness of our internal controls as of the end of the period covered by this Annual Report on Form 10-K for the year ended December 31, 2007. In making our assessment of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in *Internal Control – Integrated Framework*.

Based on management's assessment and these criteria, our management concluded that our internal control over financial reporting was effective as of December 31, 2007.

trol. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met.

Based on their evaluation as of December 31, 2007, our principal executive officer and principal financial officer were able to conclude that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

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

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

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 Board of Directors and Shareholders of Arotech Corporation:

We have audited the accompanying consolidated balance sheets of Arotech Corporation and subsidiaries as of December 31, 2007 and 2006 and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the years then ended. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. 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 schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arotech Corporation and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

Grand Rapids, Michigan
April 14, 2008

/s/ BDO Seidman, LLP
BDO Seidman, LLP

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2007	2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 3,447,671	\$ 2,368,872
Restricted collateral deposits	320,454	648,975
Escrow receivable	1,479,826	1,479,826
Available for sale marketable securities	47,005	41,166
Trade receivables (net of allowance for doubtful accounts in the amounts of \$25,000 and \$159,000 as of December 31, 2007 and 2006, respectively)	14,583,213	7,780,965
Unbilled receivables	3,271,594	6,902,533
Other accounts receivable and prepaid expenses	1,614,614	1,134,622
Inventories	7,887,820	7,851,820
Total current assets	32,652,197	28,208,779
SEVERANCE PAY FUND	2,815,040	2,246,457
OTHER LONG-TERM RECEIVABLES	386,899	262,608
PROPERTY AND EQUIPMENT, NET	5,079,796	3,740,593
INVESTMENT IN AFFILIATED COMPANY	352,168	392,398
OTHER INTANGIBLE ASSETS, NET	7,837,076	9,502,214
GOODWILL	31,358,131	30,715,225
Total long term assets	47,829,110	46,859,495
	<u>\$ 80,481,307</u>	<u>\$ 75,068,274</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,	
	2007	2006
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 4,233,288	\$ 2,808,131
Other accounts payable and accrued expenses	4,889,729	5,171,055
Current portion of capitalized leases	67,543	55,263
Current portion of promissory notes due to purchase of subsidiaries	151,450	302,900
Current portion of long term debt	103,844	—
Short term bank credit	4,557,890	3,496,008
Deferred revenues	2,903,166	1,321,311
Convertible debenture	—	2,583,629
Total current liabilities	16,906,910	15,738,297
LONG TERM LIABILITIES		
Accrued severance pay	4,853,231	4,039,049
Long term portion of promissory notes due to purchase of subsidiaries	—	151,450
Long term portion of capitalized leases	86,989	158,120
Long term portion of long term debt	1,088,498	—
Other long term liabilities	110,255	—
Deferred taxes	1,020,000	900,000
Total long-term liabilities	7,158,973	5,248,619
COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)		
MINORITY INTEREST	83,816	21,520
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – \$0.01 par value each;		
Authorized: 250,000,000 shares as of December 31, 2007 and 2006; Issued: 13,544,819 shares and 12,023,242 shares as of December 31, 2007 and 2006, respectively; Outstanding – 13,544,819 shares and 11,983,575 shares as of December 31, 2007 and 2006, respectively	135,448	120,232
Preferred shares – \$0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2007 and 2006; No shares issued and outstanding as of December 31, 2007 and 2006	—	—
Additional paid-in capital	218,551,110	217,735,860
Accumulated deficit	(162,522,558)	(159,466,123)
Treasury stock, at cost (common stock – none as of December 31, 2007 and 39,667 shares as of December 31, 2006)	—	(3,537,106)
Notes receivable from shareholders	(1,333,833)	(1,304,179)
Accumulated other comprehensive income	1,501,441	511,154
Total stockholders' equity	56,331,608	54,059,838
	<u>\$ 80,481,307</u>	<u>\$ 75,068,274</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

	2007	2006
Revenues	\$ 57,719,561	\$ 43,120,739
Cost of revenues, exclusive of amortization of intangibles	39,639,812	32,493,646
Research and development	1,877,163	1,601,454
Selling and marketing expenses	4,164,464	3,714,322
General and administrative expenses	13,158,297	11,692,816
Amortization of intangible assets	1,381,882	1,853,442
Impairment of goodwill and other intangible assets	—	316,024
Total operating costs and expenses	60,221,618	51,671,704
Operating loss	(2,502,057)	(8,550,965)
Other income	617,952	361,560
Financial expenses, net	(905,888)	(7,519,900)
Loss before minority interest in earnings of a subsidiaries, earnings from affiliated company, and income tax expenses	(2,789,993)	(15,709,305)
Income taxes	(163,916)	(232,159)
Gain (loss) from affiliated company	(40,230)	354,898
Minority interest in loss (earnings) of subsidiaries	(62,296)	17,407
Net loss	\$ (3,056,435)	\$(15,569,159)
Deemed dividend to certain stockholders	\$ —	\$ (434,185)
Net loss attributable to common stockholders	<u>\$ (3,056,435)</u>	<u>\$(16,003,344)</u>
Basic and diluted net loss per share	<u>\$ (0.27)</u>	<u>\$ (1.87)</u>
Weighted average number of shares used in computing basic and diluted net loss per share	<u>11,274,387</u>	<u>8,569,191</u>

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

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

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensa- tion	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, 2006, as previously reported	6,221,194	\$ 870,969	\$ 193,949,882	\$ (142,996,964)	\$ (389,303)	\$(3,537,106)	\$ (1,256,777)	\$ (375,445)	\$	\$ 46,265,256
Prior Period Adjustment	-	-	-	(900,000)	-	-	-	-	-	(900,000)
Balance as of January 1, 2006, as adjusted	6,221,194	\$ 870,969	\$ 193,949,882	\$ (143,896,964)	\$ (389,303)	\$(3,537,106)	\$ (1,256,777)	\$ (375,445)	-	45,365,256
Adjustment of fractional shares due to reverse split	(142)	(808,757)	808,757	-	-	-	-	-	-	-
FAS 123R reclassification	-	-	(389,303)	-	389,303	-	-	-	-	-
Principal installment of convertible debenture payment in shares	4,184,855	41,848	18,477,301	-	-	-	-	-	-	18,519,149
Warrants exercise	745,549	7,455	4,343,180	-	-	-	-	-	-	4,350,635
Stock based compensation	-	-	500,545	-	-	-	-	-	-	500,545
Stock options and restricted stock	871,786	8,717	(1,904)	-	-	-	-	-	-	6,813
Interest accrued on notes receivable from shareholders	-	-	47,402	-	-	-	(47,402)	-	-	-
Other comprehensive loss – foreign currency translation adjustment	-	-	-	-	-	-	-	885,733	885,733	885,733
Other comprehensive loss – unrealized gain on available for sale marketable securities	-	-	-	-	-	-	-	866	866	866
Net loss	-	-	-	(15,569,159)	-	-	-	-	(15,569,159)	(15,569,159)
Total comprehensive loss	-	-	-	-	-	-	-	-	(14,682,560)	-
Balance as of December 31, 2006	12,023,242	\$ 120,232	\$ 217,735,860	\$ (159,466,123)	\$ 0	\$(3,537,106)	\$ (1,304,179)	\$ 511,154	\$	\$ 54,059,838

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

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

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	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, 2007	12,023,242	\$ 120,232	\$ 217,735,860	\$ (159,426,123)	\$ (3,537,106)	\$ (1,304,179)	\$ 511,154	\$ -	\$ 54,059,838
Principal installment of convertible debenture payment in shares	930,125	9,301	2,873,454	-	-	-	-	-	2,882,755
Treasury shares cancellation	(39,666)	(396)	(3,536,710)	-	3,537,106	-	-	-	-
Stock based compensation	-	-	1,417,521	-	-	-	-	-	1,417,521
Stock options and restricted stock	631,118	6,311	31,331	-	-	-	-	-	37,642
Interest accrued on notes receivable from shareholders	-	-	29,654	-	-	(29,654)	-	-	-
Other comprehensive loss – foreign currency translation adjustment	-	-	-	-	-	-	988,740	988,740	988,740
Other comprehensive loss – unrealized gain on available for sale marketable securities	-	-	-	-	-	-	1,547	1,547	1,547
Net loss	-	-	-	(3,056,435)	-	-	-	(3,056,435)	(3,056,435)
Total comprehensive loss	-	-	-	-	-	-	-	(2,066,148)	-
Balance as of December 31, 2007	13,544,819	\$ 135,448	\$ 218,551,110	\$ (162,522,558)	\$ 0	\$ (1,333,833)	\$ 1,501,441	\$ -	\$ 56,331,608

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

	2007	2006
Cash flows from operating activities:		
Net loss	\$ (3,056,435)	\$(15,569,159)
Adjustments required to reconcile net loss to net cash used in operating activities:		
Minorities interests in loss (earnings) of subsidiary	62,296	(17,407)
Loss (gain) from affiliated company	40,230	(354,898)
Depreciation	1,376,749	1,966,748
Amortization of intangible assets, capitalized software costs and impairment of intangible assets	1,953,164	2,857,891
Remeasurement of liability in connection to warrants granted	—	(700,113)
Accrued severance pay, net	245,599	194,810
Compensation related to shares issued to employees, consultants and directors	1,417,521	507,081
Impairment of property and equipment	—	32,485
Financial expenses in connection with convertible debenture principle repayment	280,382	5,395,338
Amortization related to warrants issued to the holders of convertible debentures and beneficial conversion feature	18,745	1,485,015
Amortization of deferred charges related to convertible debentures issuance	44,253	780,719
Capital loss (gain) from sale of property and equipment	56,224	(1,842)
Decrease (increase) in trade receivables	(6,802,248)	3,631,978
Decrease (increase) in other accounts receivable and prepaid expenses	(706,569)	605,610
Decrease in deferred taxes	100,323	6,788
Decrease (increase) in inventories	(36,000)	83,926
Increase (decrease) in unbilled revenues	3,630,939	(1,674,029)
Increase in deferred revenues	1,581,854	718,290
Increase (decrease) in trade payables	1,425,156	(3,156,665)
Decrease in other accounts payable and accrued expenses	(137,834)	(296,866)
Net cash provided by (used in) operating activities from continuing operations	1,494,349	(3,504,300)
Net cash used in operating activities from discontinued operations	—	(120,000)
Net cash provided by (used in) operating activities	\$ 1,494,349	\$ (3,624,300)
Cash flows from investing activities:		
Purchase of property and equipment	(1,594,426)	(1,412,383)
Increase in capitalized software costs	(15,750)	(688,443)
Payment of additional required payout for FAAC acquisition	—	(630,350)
Repayment of promissory notes related to acquisition of subsidiaries	(302,900)	—
Proceeds from sale of property and equipment	36,061	—
Increase in escrow receivable	—	(1,479,826)
Decrease in restricted cash	322,682	3,723,611
Net cash used in investing activities	\$ (1,554,333)	\$ (487,391)

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

	2007	2006
Forward	(59,985)	(4,111,691)
Cash flows from financing activities:		
Proceeds from exercise of options	37,642	250
Proceeds from exercise of warrants	—	4,350,635
Repayment of convertible debentures	—	(5,204,167)
Repayment of long term loan	(21,468)	(149,414)
Increase in short term bank credit	1,061,883	1,455,309
Net cash provided by financing activities	1,078,057	452,613
Increase (decrease) in cash and cash equivalents	1,018,073	(3,659,078)
Cash accretion (erosion) due to exchange rate differences	60,726	(122,702)
Cash and cash equivalents at the beginning of the year	2,368,872	6,150,652
Cash and cash equivalents at the end of the year	<u>\$ 3,447,671</u>	<u>\$ 2,368,872</u>
Supplementary information on non-cash transactions:		
Payment of principle installment of convertible debenture in shares	\$ 2,882,753	\$ 18,519,149
Mortgage note payable (seller financed) issued for purchase of building	\$ 1,115,000	\$ —
Interest paid during the period	\$ 662,789	\$ 2,018,061

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. Corporate structure:

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 FAAC Corporation, a wholly-owned subsidiary based in Ann Arbor, Michigan; 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; M.D.T. Protective Industries, Ltd. (“MDT”), a majority-owned (now wholly-owned; see Note 18.b.) subsidiary based in Lod, Israel; MDT Armor Corporation, a majority-owned (now wholly-owned; see Note 18.b.) subsidiary based in Auburn, Alabama; and Armour of America, Incorporated, a wholly-owned subsidiary based in Auburn, Alabama.

Revenues derived from the Company’s largest customers in 2007 and 2006 are described in Note 16.d.

b. Acquisition of FAAC:

The Company had 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 and 2006, the Company accrued an amount of \$603,764 and \$630,000, respectively, in respect of such earnout obligation to increase FAAC’s goodwill. The \$151,450 shown as promissory notes in the balance sheet is the portion of the 2006 earnout that is paid in equal installments that started in January 2007 and will be paid in full in June 2008. The promissory note is non-interest bearing.

c. Acquisition of AoA:

The total purchase price consisted of \$19,000,000 in cash, with additional possible earn-outs if AoA was 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. As of December 31, 2007, the Company had reduced the \$3.0 million escrow held by the seller of AoA by \$1,520,174 for a putative claim against such escrow in respect of such earn-out obligation. When the contingency on the earn-out provision is resolved, the additional consideration, if any, will be recorded as additional purchase price. Any recovery of the previously expensed escrow amount will be recorded as income in the period received.

In March 2007, the Company filed a Demand for Arbitration with the American Arbitration Association against the seller of AoA. The Company sought the return of the \$3.0 million escrow, plus interest. The seller of AoA asserted counterclaims against the Company in the arbitration, alleging (i) that he is entitled to keep the \$3.0 million, (ii) that he is entitled to an additional \$3.0 million in post-sale earnouts, and (iii) that he is entitled to \$70,000 in compensation (plus interest and statutory penalties) wrongfully withheld by the Company when it constructively terminated his employment.

In December 2007, the matter was brought before an arbitration panel and in February 2008, the arbitration panel issued a decision, granting the seller’s counterclaim for \$70,000 in compensation, awarding the Company the entire \$3.0 million escrow (less the \$70,000 in compensation (with simple interest but without statutory penalties)), and awarding the Company \$135,000 in attorneys’ fees. The federal district court for the Southern District of New York has not yet ruled upon the Company’s petition to confirm the arbitration award.

d. 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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

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.

In 2007, the Company evaluated all goodwill and it was determined that there was no impairment.

In 2006, the Company identified an additional \$316,024 in potential earn-out obligations in an amount equal to the revenues realized by the Company from certain specific programs at AoA. This expense is shown as impairment expense since the full amount of AoA goodwill had been previously written off in 2005.

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.

e. Reverse stock split:

On June 20, 2006, the Company filed a Certificate of Amendment with the Delaware Secretary of State which served to effect, as of 7:00 a.m. e.d.t. on June 21, 2006, a one-for-fourteen reverse split of the Company's common stock. As a result of the reverse stock split, every fourteen shares of the Company's common stock were combined into one share of common stock; any fractional shares created by the reverse stock split were eliminated. The par value of the shares remained unchanged. The reverse stock split affected all of the Company's common stock, stock options, warrants and convertible debt outstanding immediately prior to the effective date of the reverse stock split. The reverse split reduced the number of shares of the Company's common stock outstanding at June 21, 2006 from 118,587,361 shares to 8,468,957 shares. All references to common share and per common share amounts for all periods presented have been retroactively restated to reflect this reverse split.

f. Related parties

The Company has a consulting agreement with Sampen Corporation that it executed in March 2005, effective as of January 1, 2005. Sampen is a New York corporation owned by members of the immediate family of one of the Company's executive officers, and this executive officer is an employee of both the Company and of Sampen. The term of this consulting agreement as extended expires on December 31, 2008, and is extended automatically for additional terms of two years each unless either Sampen or the Company terminate the agreement sooner.

Pursuant to the terms of the Company's agreement with Sampen, Sampen provides one of its employees to the Company for such employee to serve as the Company's Chief Operating Officer. The Company pays Sampen \$12,800 per month, plus an annual bonus, on a sliding scale, in an amount equal to a minimum of 20% of Sampen's annual base compensation then in effect, up to a maximum of 75% of its annual base compensation then in effect if the results the Company actually attains for the year in question are 120% or more of the amount the Company budgeted at the beginning of the year. The Company also pays Sampen, to cover the cost of the Company's use of Sampen's offices as an ancillary New York office and the attendant expenses and insurance costs, an amount equal to 16% of each monthly payment of base compensation.

During the years ended December 31, 2007 and 2006 the Company paid Sampen a total of \$219,354 and \$208,896, respectively.

On December 3, 1999, Robert S. Ehrlich purchased 8,928 shares of the Company's common stock out of the Company's treasury at the closing price of the Company's common stock on December 2, 1999. Payment was rendered by Mr. Ehrlich in the form of non-recourse promissory notes due in 2009 in the amount

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

of \$167,975, bearing simple annual interest at a rate of 2%, secured by the shares of common stock purchased and other shares of common stock previously held by him. As of December 31, 2007, the aggregate amount outstanding pursuant to this promissory note was \$201,570.

On February 9, 2000, Mr. Ehrlich exercised 9,404 stock options. Mr. Ehrlich paid the exercise price of the stock options and certain taxes that the Company paid on his behalf by giving the Company a non-recourse promissory note due in 2025 in the amount of \$789,991, bearing annual interest (i) as to \$329,163, at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, and (ii) as to \$460,828, at 4% over the then-current percentage increase in the Israeli consumer price index between the date of the loan and the date of the annual interest calculation, secured by the shares of the Company's common stock acquired through the exercise of the options and certain compensation due to Mr. Ehrlich upon termination. As of December 31, 2007, the aggregate amount outstanding pursuant to this promissory note was \$820,809.

On June 10, 2002, Mr. Ehrlich exercised 3,571 stock options. Mr. Ehrlich paid the exercise price of the stock options by giving the Company a non-recourse promissory note due in 2012 in the amount of \$36,500, bearing simple annual interest at a rate equal to the lesser of (i) 5.75%, and (ii) 1% over the then-current federal funds rate announced from time to time, secured by the shares of the Company's common stock acquired through the exercise of the options. As of December 31, 2007, the aggregate amount outstanding pursuant to this promissory note was \$45,388.

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

A majority of the revenues of the Company and most of its subsidiaries 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 income 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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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, 2007 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 2007 and 2006, the Company wrote off \$150,681 and \$292,864, of obsolete inventory respectively, which has been included in the cost of revenues.

Cost is determined as follows:

Raw and packaging materials – by the average cost method or FIFO.

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 2007 and 2006).

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 and equipment	10 - 25 (mainly 10)
Leasehold improvements	By the shorter of the term of the lease or the life of the asset

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

i. 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 2007 and 2006, 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 (Training and Simulation Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery 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 probable, 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. During 2006 \$741,165 in estimated losses were identified and expensed.

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 collectability 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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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.

j. 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.

k. 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. See Note 18.

l. 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 net realizable value of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2007.

m. 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.

n. 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 deposits, 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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

o. 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, non vested restricted stock 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 1,791,562 and 1,781,984, for the years ended December 31, 2007 and 2006, respectively.

p. Accounting for stock-based compensation

Effective January 1, 2006, the Company started to account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R) ("SFAS No. 123(R)"), "Share-Based Payment," using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. The Company determines the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values. The adoption of SFAS No. 123(R) resulted in a reduction in income of \$500,445 in 2006, which reduced basic and diluted EPS for the year by \$0.06.

The fair value for the 2006 options granted 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 4.64% (based on three-year U.S. Treasury bonds); a dividend yield of 0.0%, a volatility factor of the expected market price of the common stock of 1.33 (based on historical volatility of the stock over the previous three years); and a weighted-average expected life of the option of three years. The Company did not grant any options in 2007. The Company assumed a 20% forfeiture rate for options for both years. The Company uses a 10% forfeiture rate for restricted stock.

q. Fair value of financial instruments:

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

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

r. Severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. Israeli employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability for all of its Israeli employees is fully provided 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 EITF 88-1: "Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan" As of December 31, 2007 and 2006, the accumulated severance pay in that regard amounted to \$2,081,857 and \$2,163,264, 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 for the benefit of the Chief Executive Officer, with payments to be made pursuant to an agreed-upon schedule. As of December 31, 2007, a total of \$618,097 had been deposited. These funds continue to be owned by the Company, which benefits from all gains and bears the risk of all losses resulting from investments of these 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, 2007 and 2006 amounted to \$334,749 and \$563,302, respectively.

s. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2007 and 2006 was approximately \$92,775 and \$21,000, respectively.

t. New accounting pronouncements:

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*, to further enhance the accounting and financial reporting related to business combinations. SFAS No. 141(R) establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Therefore, the effects of the Corporation's adoption of SFAS No. 141(R) will depend upon the extent and magnitude of acquisitions after December 31, 2008.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. The Statement does not require any new fair value measurements and was initially effective for the Corporation beginning January 1, 2008. In February 2008, the FASB approved the issuance of FASB Staff Position (FSP) FAS 157-2. FSP FAS 157-2 defers the effective date of SFAS No. 157 until January 1, 2009 for nonfinancial assets and nonfinancial liabilities except those items recognized or disclosed at fair value on an annual or more frequently recurring basis. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement permits entities to choose to measure eligible items at fair value at specified election dates. For items for which the fair value option has been elected, unrealized gains and losses are to be reported in earnings at each subsequent reporting date. The fair value option is irrevocable unless a new election date occurs, may be applied instrument by instrument, with a few exceptions, and applies only to entire instruments and not to portions of instruments. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting. SFAS No. 159 is effective for the Corporation beginning January 1, 2008. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*, to create accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 establishes accounting and reporting standards that require (1) the ownership interest in subsidiaries held by parties other than the parent to be clearly identified and presented in the consolidated balance sheet within equity, but separate from the parent's equity, (2) the amount of consolidated net income attributable to the parent and the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of income, (3) changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary to be accounted for consistently, (4) when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary to be initially measured at fair value, and (5) entities to provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 applies to fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, and prohibits early adoption. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

u. Reclassification:

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

NOTE 3:– RESTRICTED COLLATERAL DEPOSITS

	December 31,	
	2007	2006
Short-term:		
Deposits in connection with MDT Israel projects	\$ 254,668	\$ –
Deposits in connection with FAAC projects	–	535,151
Restricted cash in connection with interest payment to convertible debenture holders.		113,824
Deposits in connection with EFL projects	65,786	–
Total Restricted Collateral	<u>\$ 320,454</u>	<u>\$ 648,975</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 4: – AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2007 and 2006:

	Cost		Unrealized gains		Estimated fair value	
	2007	2006	2007	2006	2007	2006
Available for sale marketable securities	\$ 41,166	\$ 36,708	\$ 5,839	\$ 4,458	\$ 47,005	\$ 41,166

NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2007	2006
Government authorities	\$ 259,036	\$ 213,362
Employees	60,950	77,836
Prepaid expenses	790,157	292,496
Deferred taxes	–	58,032
Other	504,471	492,896
	<u>\$ 1,614,614</u>	<u>\$ 1,134,622</u>

NOTE 6:– INVENTORIES

	December 31,	
	2007	2006
Raw and packaging materials	\$ 6,043,170	\$ 4,556,250
Work in progress	1,583,790	3,186,843
Finished products	260,860	108,727
	<u>\$ 7,887,820</u>	<u>\$ 7,851,820</u>

NOTE 7:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2007	2006
Cost:		
Computers and related equipment	\$ 2,494,370	\$ 2,080,462
Motor vehicles	561,737	674,737
Office furniture and equipment	1,194,132	1,015,054
Machinery, equipment and installations	4,485,959	4,108,763
Buildings	1,172,072	–
Land	115,538	–
Leasehold improvements	846,271	887,311
Demo inventory	1,150,129	643,458
	<u>\$12,020,208</u>	<u>\$ 9,409,785</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 7:– PROPERTY AND EQUIPMENT, NET (Cont.)

	December 31,	
	2007	2006
Accumulated depreciation:		
Computers and related equipment	2,061,044	1,626,066
Motor vehicles	249,627	234,023
Office furniture and equipment	536,472	585,069
Machinery, equipment and installations	3,132,202	2,466,598
Buildings	25,045	–
Leasehold improvements	407,030	385,196
Demo inventory	528,992	372,240
	<u>6,940,412</u>	<u>5,669,192</u>
Depreciated cost	<u>\$ 5,079,796</u>	<u>\$ 3,740,593</u>

b. Depreciation expense amounted to \$1,376,749 and \$1,966,748 for the years ended December 31, 2007 and 2006, respectively.

c. In March 2007, the Company purchased 16,700 square feet of space in Auburn, Alabama for approximately \$1.1 million pursuant to a seller-financed secured purchase money mortgage. Half the mortgage is payable over ten years in equal monthly installments based on a 20-year amortization of the full principal amount, and the remaining half is payable at the end of ten years in a balloon payment.

As for liens, see Note 11.d.

NOTE 8:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

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

	12/31/06	Additions	Adjustments (currency)	12/31/07
Simulation	\$ 24,235,419	\$ –	\$ –	\$ 24,235,419
Battery	5,413,210	–	533,439	5,946,649
Armor	1,066,596	–	109,467	1,176,063
Total	<u>\$ 30,715,225</u>	<u>\$ –</u>	<u>\$ 642,906</u>	<u>\$ 31,358,131</u>

b. Other intangible assets

	December 31,			
	2007		2006	
	Cost	Net Book Value	Cost	Net Book Value
Technology	\$ 6,405,000	\$ 2,305,000	\$ 6,405,000	\$ 2,898,750
Capitalized software costs	1,720,991	442,816	1,701,150	975,664
Backlog	682,000	–	682,000	–
Covenants not to compete	99,000	–	99,000	9,900
Customer list	7,548,645	3,846,117	7,548,645	4,591,065
Certification	246,969	–	246,969	51,877
	<u>16,702,605</u>	<u>6,593,933</u>	<u>16,682,764</u>	<u>8,527,256</u>
Exchange differences	444,143		175,958	
Less - accumulated amortization	<u>(10,108,672)</u>		<u>(8,155,508)</u>	
Amortized cost	<u>7,038,076</u>		<u>8,703,214</u>	
Trademarks	799,000		799,000	
Net book value	<u>\$ 7,837,076</u>		<u>\$ 9,502,214</u>	

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 8:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET (Cont.)

Amortization expense amounted to \$1,953,164 and \$2,857,891 for the years ended December 31, 2007 and 2006, respectively, including amortization of capitalized software costs of \$552,689 and \$285,467, respectively.

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

	Year ended December 31,
2008	\$ 1,276,075
2009	1,235,632
2010	1,197,990
2011	1,197,990
2012	621,740
2013 and forward	621,691
Total	<u>\$ 6,151,117</u>

Goodwill and other intangible assets are adjusted on a quarterly basis for any change due to currency fluctuations and any variation is included in the accumulated other comprehensive loss on the Balance Sheet.

NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS

The Company and/or certain of its subsidiaries have \$8.0 million authorized in credit lines from certain banks, of which \$475,000 is denominated in NIS and carries various approximate interest rates of prime rate + 2.6 to 4.2% and \$7.5 million is denominated in U.S. dollars (the Company's primary line) and carries an interest rate of lender's prime rate + 0.25%, the interest rate charged by the bank for this line was 7.5% at December 31, 2007. As of December 31, 2007, \$5.1 million was utilized from the Company's primary line, out of which \$530,000 is related to two letters of credit issued to customers of two of the Company's subsidiaries.

These lines of credit are secured by the accounts receivable, inventory and marketable securities of the relevant subsidiary of the Company.

NOTE 10:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2007	2006
Employees and payroll accruals	\$ 1,531,157	\$ 1,288,601
Accrual for expected loss	–	829,973
Accrued vacation pay	530,850	442,068
Accrued expenses	1,813,947	1,380,150
Government authorities	401,826	815,374
Advances from customers	611,948	414,889
	<u>\$ 4,889,728</u>	<u>\$ 5,171,055</u>

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.

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NOTE 11: –COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

Royalties paid or accrued for the years ended December 31, 2007 and 2006 to the OCS amounted to \$15,063 and \$30,402, respectively.

As of December 31, 2007, the total contingent liability to the OCS was approximately \$10,356,671. The Company regards the probability of this contingency coming to pass in any material amount to be low.

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

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

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2007.

As of December 31, 2007, 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 minimum rental payments under non-cancelable operating leases are as follows:

	<u>December 31</u>
2008	\$ 637,760
2009	495,504
2010	502,031
2011	507,349
2012	513,875
Thereafter	1,645,672
Total	<u>\$ 4,302,191</u>

Total rent expenses for the years ended December 31, 2007 and 2006 were \$890,406 and \$878,908, respectively.

The existing leases have terms from 3 to 5 years and are for equipment purchases. The equipment is classified under machinery and equipment in fixed assets.

The table below details the original value, depreciation and net book value of the leased assets. The net book value is included in the property and equipment totals in the balance sheet.

<u>Leased Assets</u>	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
Equipment	\$ 249,532	\$ 249,532
Less: Accumulated Depreciation	(97,789)	(20,130)
Net book value	<u>\$ 151,743</u>	<u>\$ 229,402</u>

The table below details the remaining liability of the capital lease obligations.

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NOTE 11: –COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

<u>Liabilities</u>	<u>December 31, 2007</u>
Obligations under capital leases:	
Current	\$ 67,543
Non-current	86,989
Total	<u>\$ 154,532</u>

The table below details the minimum future lease payments due along with the present value of the net minimum lease payments as of December 31, 2007.

<u>Future Minimum Lease Payments</u>	<u>December 31</u>
2008	\$ 67,543
2009	42,394
2010	30,017
2011	14,578
2012 and forward	–
Total minimum lease payments	<u>154,532</u>

c. **Guarantees:**

The Company obtained bank guarantees in the amount of \$235,000 in connection (i) obligations of two of the Company's subsidiaries to the Israeli customs authorities, (ii) the obligation of one of the Company's subsidiaries to secure the return of products loaned to the Company from one of its customers, and (iii) the obligation of one of the Company's subsidiaries to secure a required letter of credit required under a long term contract. In addition, the Company has two outstanding letters of credit in the amounts of \$334,000 and \$196,210 to two of its subsidiaries' customers.

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 (that is, liens that apply not only to assets owned at the time but also to after-acquired assets) on all of its assets, in favor of the State of Israel.

FAAC has a \$7.5 million line of credit secured by the assets of the Company and its active United States subsidiaries and guaranteed by the Company and its active subsidiaries.

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.

e. **Litigation and other claims:**

As of December 31, 2007, there were no pending material 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 and administrative costs. Trial in this matter is in progress. 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 May 2007, two purported class action complaints (the "Complaint") were filed in the United States District Court for the Eastern District of New York against the Company and certain of its officers and directors. These two cases were consolidated in June 2007. A similar case filed in the United States District Court for the Eastern District of Michigan in March 2007 was withdrawn by the plaintiff in June 2007. The Complaint seeks class status on behalf of all persons who purchased the Company's securities between November 9, 2004 and November 14, 2005 (the "Period") and alleges violations by the Company and certain of

AROTECH CORPORATION AND ITS SUBSIDIARIES
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NOTE 11: –COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

its officers and directors of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, primarily related to the Company's acquisition of AoA in 2005 and certain public statements made by the Company with respect to its business and prospects during the Period. The Complaint also alleges that the Company did not have adequate systems of internal operational or financial controls, and that the Company's financial statements and reports were not prepared in accordance with GAAP and SEC rules. The Complaint seeks an unspecified amount of damages. A lead plaintiff has been named, and the plaintiff's consolidated amended complaint was filed in September 2007. The Company's motion to dismiss the complaint was filed in November 2007, but a decision on its motion is not expected until mid-2008. Although the ultimate outcome of this matter cannot be determined with certainty, the Company believes that the allegations stated in the Complaint are without merit and the Company and its officers and directors named in the Complaint intend to defend themselves vigorously against such allegations.

NOTE 12:– CONVERTIBLE DEBT, DETACHABLE WARRANTS AND OTHER LONG TERM DEBT

As of July 31, 2007, all convertible notes had been repaid in full

a. 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 were convertible at any time prior to September 30, 2006 at a conversion price of \$16.10 per share, or a maximum aggregate of 310,559 shares of common stock.

As part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 89,286 shares of common stock at any time prior to September 30, 2006 at a price of \$20.125 per share. In March 2006, 8,929 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 3,571 shares at an exercise price of \$8.316. As a result of this repricing of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$24,531.

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 2006, the Company recorded an expense of \$22,142 which was attributable to amortization of debt discount and beneficial conversion feature related to the convertible debenture over its term. These expenses were included in the financial expenses.

During 2006, the Company paid the remaining principal amount of \$150,000 in respect of these secured convertible debentures.

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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$6.0 million due September 30, 2006. These debentures were convertible at any time prior to September 30, 2006 at a conversion price of \$20.30 per share, or a maximum aggregate of 295,567 shares of common stock.

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NOTE 12:— CONVERTIBLE DEBT, DETACHABLE WARRANTS AND OTHER LONG TERM DEBT
(Cont.)

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 107,143 shares of common stock at any time prior to December 18, 2006 at a price of \$25.375 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 74,143 shares of common stock at any time prior to December 31, 2006 at a price of \$30.80 per share. In February and March 2006, an aggregate of 55,607 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holders of these warrants received new warrants to purchase an aggregate of 22,244 shares at an exercise price of \$8.316. In April 2006, 11,121 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 4,449 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$39,221.

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 2006, the Company recorded an expense of \$1,168,573 which was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term. These expenses were included in the financial expenses.

During 2006, the Company paid in cash the remaining principal amount of \$4,387,500 in respect of these secured convertible debentures.

c. 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 convertible notes ("Notes") having a final maturity date of March 31, 2008.

Under the terms of the Purchase Agreement, as amended, the Company granted the investors (i) a second position security interest in the assets and receivables of FAAC Incorporated, and in the receivables of MDT Armor Corporation related to MDT's David order with the U.S. Army (junior to the security interest of a bank that had, at that time, extended to FAAC Corporation a \$6.0 million line of credit) and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries and in the stock of all of the Company's active United States subsidiaries, as well as in any stock that the Company acquires in future Acquisitions (as defined in the securities purchase agreement). The Company's active United States subsidiaries are also acting as guarantors of the Company's obligations under the Notes. Since the senior notes were paid in full during 2007, these security interests no longer apply.

The Notes are convertible at the investors' option at a fixed conversion price of \$14.00. 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 was obligated to 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 in cash and/or, at the Company's option, in stock by forcing conversion of the Notes, provided certain conditions are met. In the event of an election by the Company to make such payments in stock by forcing conversion of the

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NOTE 12:— CONVERTIBLE DEBT, DETACHABLE WARRANTS AND OTHER LONG TERM DEBT
(Cont.)

notes, the price used to determine the number of shares to be issued was 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 Company issued warrants, which were not exercisable for the six month period following closing, to purchase up to 375,000 shares of common stock (30% warrant coverage) at an exercise price of \$15.40 per share. These warrants were exercisable until March 29, 2007.

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 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 was 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.

As to EITF No. 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 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 \$14.00. 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 \$14.00.

As a result of a prepayment conversion in April 2006, the Company made the final payment in respect of the Notes in July 2007.

During 2007 and 2006, the Company recorded expenses of \$18,745 and \$1,485,015, respectively, attributable to amortization related to warrants issued to the holders of the Notes and the beneficial conversion feature. During 2007 and 2006, the Company also recorded expenses of \$280,382 and \$5,395,338, respectively, attributable to financial expenses in connection with convertible debenture principle repayment of the Notes. Additionally, during 2007 and 2006, the Company recorded expenses of \$44,253 and \$780,719, respectively, attributable to amortization of deferred charges related to issuance of the Notes.

During 2007 and 2006, the Company issued a total of 930,125 and 4,184,855 shares, respectively, in payment of the debentures.

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NOTE 12:— CONVERTIBLE DEBT, DETACHABLE WARRANTS AND OTHER LONG TERM DEBT
(Cont.)

d. Other Long Term Debt:

1. Mortgage Note, Auburn, Alabama:

In March 2007, the Company purchased 16,700 square feet of space in Auburn, Alabama for approximately \$1.1 million pursuant to a seller-financed secured purchase money mortgage. Half the mortgage is payable over ten years in equal monthly installments based on a 20-year amortization of the full principal amount, and the remaining half is payable at the end of ten years in a balloon payment. The note requires a payment (principal and interest) of approximately \$9,300 per month at an interest rate of 8% per annum. The balance of this note is shown in the short and long term sections of the balance sheet.

Mortgage Future Payments		
2008	\$	25,021
2009		27,105
2010		29,355
2011		31,792
2012		34,423
Thereafter		950,101
	\$	<u>1,097,797</u>

The Company has additional long term debt outstanding of approximately \$95,000, primarily vehicle loans. This amount is payable \$79,000 in 2008 and \$15,000 in 2009.

NOTE 13:— STOCKHOLDERS' 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. Warrants:

1. In March 2006, 19,625 of the Company's warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received new warrants to purchase 7,850 shares at an exercise price of \$8.316. As a result of this repricing of the existing warrants and the issuance of these new warrants, the Company recorded during 2006 a deemed dividend in the amount of \$28,369.

2. In January 2004, in connection with a purchase of the Company's securities by certain investors, the Company granted three-year warrants to purchase up to an aggregate of 702,888 shares of the Company's common stock at any time beginning six months after closing at an exercise price per share of \$26.32.

In July 2004 an aggregate of 531,915 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 531,915 shares of the Company's common stock at an exercise price per share of \$19.32. 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.

In March 2006, 56,991 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase an aggregate of 22,796 shares at an exercise price of \$8.316. In April 2006, an additional 75,988 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 30,395

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NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$270,336.

3. On July 14, 2004, warrants to purchase 629,588 shares of common stock, having an aggregate exercise price of \$16,494,194, net of issuance expenses, were exercised. Out of the shares issued in conjunction with the exercise of these warrants, 80,357 shares were issued upon exercise of warrants issued in connection with the Company's former 8% Secured Convertible Debentures due September 30, 2006 and 531,915 shares were issued upon exercise of warrants issued in the transaction referred to in the Note 13.b.2. above; the remaining 17,316 shares were issued upon exercise of a warrant that the Company issued to an investor in May 2001. In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 622,662 new five-year warrants to purchase shares of common stock at an exercise price of \$19.32 per share

In February and March 2006, an aggregate of 501,216 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holders of these warrants received new warrants to purchase an aggregate of 200,487 shares at an exercise price of \$8.316. In April 2006, an additional 16,071 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 6,429 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 deemed dividend in the amount of \$71,728.

As to EITF 00-19, since the terms of the new warrants referred to above provided that the warrants were exercisable subject to the Company obtaining shareholder 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 until obtaining shareholder approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the shareholder approval), using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$700,113 has been recorded as finance income.

4. 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 \$3.0 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) 32,143 shares of common stock, and (ii) five-year warrants to purchase up to an additional 32,143 shares of common stock at a purchase price of \$26.74 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.

5. As of December 31, 2007, the Company's outstanding warrants totaled 493,851 with expiration dates through July 2009 with exercise prices ranging from \$8.32 to \$31.50.

c. 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.

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NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

1. 1998 Employee Option Plan – as amended, 339,286 shares reserved for issuance, of which 86,194 were available for future grants to employees and consultants as of December 31, 2007.
2. 1995 Non-Employee Director Plan – 71,429 shares reserved for issuance, of which 71,429 stock options were issued and outstanding as of December 31, 2007. Pursuant to the terms of this Plan, no new options were issuable under this Plan after September 28, 2005.
3. 2004 Employee Option Plan – 535,714 shares reserved for issuance, of which 277,351 were available for future grants to employees and consultants as of December 31, 2007.
4. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 708,882 were available for future grants to outside directors as of December 31, 2007.
5. 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 also generally vest after three years or pursuant to defined performance criteria; in the event that employment is terminated within that period, unvested restricted shares revert back to the Company.

Restricted stock generally vests over three years. Half of these shares are subject only to service requirements and half vest subject to service and performance requirements. The performance requirements are determined annually by the Board. These performance requirements were met in 2007 but have not been determined for future years. Shares subject to performance requirements carryover to subsequent years if the performance requirements are not met in a particular year. Vesting will not occur if the performance requirements are never met. In the event that employment is terminated prior to vesting, all unvested restricted shares revert back to the Company.

6. 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, 2007 and 2006, and changes during the years ended on those dates, is presented below:

Stock Options:

	2007		2006	
	Amount	Weighted average exercise price \$	Amount	Weighted average exercise price \$
Options outstanding at beginning of year	623,686	\$ 8.20	606,068	\$ 10.23
Changes during year:				
Granted (1) (2)	–	\$ –	124,000	\$ 2.86
Exercised	–	\$ –	(1,786)	\$ 0.14
Forfeited	(332,305)	\$ 13.34	(104,596)	\$ 13.75
Options outstanding at end of year	291,381	\$ 2.34	623,686	\$ 8.20
Options vested at end of year	222,260	\$ 2.47	486,526	\$ 9.22
Options expected to vest	55,296	\$ 2.34	109,728	\$ 8.20

(1) Includes 0 and 12,500 options granted to directors and executive officers in 2007 and 2006, respectively.

(2) 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

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NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

in respect of options and restricted shares to employees and directors in 2007 and 2006 was \$1,417,521 and \$500,545, respectively.

The table below summarizes the intrinsic value of options for each year.

	<u>Vested</u>	<u>Unvested</u>
2007⁽¹⁾	\$ —	\$ —
2006	\$ 1,039	\$ 31,220

⁽¹⁾Calculated intrinsic value is less than zero.

Restricted Shares:

	<u>2007</u>		<u>2006</u>	
	<u>Shares</u>	<u>Weighted average fair value at grant date</u>	<u>Shares</u>	<u>Weighted average fair value at grant date</u>
Nonvested at the beginning of the year	863,572	\$ 2.51	54,286	\$ 1.41
Changes during year:				
Granted	436,118	\$ 2.51	860,000	\$ 2.58
Vested	(500,238)	\$ 2.62	(48,571)	\$ 1.42
Forfeited	—	\$ —	(2,143)	\$ 1.73
Nonvested at the end of the year	<u>799,452</u>	<u>\$ 2.38</u>	<u>863,572</u>	<u>\$ 2.51</u>
Restricted shares vested at end of year	<u>548,809</u>	<u>\$ 2.51</u>	<u>48,571</u>	<u>\$ 1.42</u>

7. The options outstanding as of December 31, 2007 have been separated into ranges of exercise price, as follows:

<u>Range of exercise prices</u>	<u>Total options outstanding</u>			<u>Vested options outstanding</u>	
	<u>Amount outstanding at December 31, 2007</u>	<u>Weighted average remaining contractual life</u>	<u>Weighted average exercise price</u>	<u>Amount exercisable at December 31, 2007</u>	<u>Weighted average exercise price</u>
<u>\$</u>		<u>Years</u>	<u>\$</u>		<u>\$</u>
0.00-28.00	289,483	3.71	2.14	220,362	2.20
28.01-56.00	1,898	1.96	34.24	1,898	34.24
Total	<u>291,381</u>	3.70	2.35	<u>222,260</u>	2.47

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

	<u>Equals market price</u>		<u>Less than market price</u>	
	<u>Year ended December 31, 2007</u>	<u>2006</u>	<u>Year ended December 31, 2007</u>	<u>2006</u>
Weighted average exercise prices	\$ —	\$ 2.86	\$ —	\$ —
Weighted average fair value on grant date	\$ —	\$ 2.11	\$ —	\$ —

9. Options issued to consultants:

The Company's outstanding options to consultants are as follows:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

	<u>2007</u>		<u>2006</u>	
	<u>Amount</u>	<u>Weighted average exercise price</u>	<u>Amount</u>	<u>Weighted average exercise price</u>
Options outstanding at beginning of year	11,878	\$ 53.20	11,878	\$53.20
Changes during year:				
Granted	–	\$ –	10,000	\$ 1.90
Exercised	–	\$ –	(10,000)	\$ 1.90
Forfeited or cancelled	–	\$ –	–	\$ –
Options outstanding at end of year	<u>11,878</u>	<u>\$ 53.20</u>	<u>11,878</u>	<u>\$ 53.20</u>
Options vested at end of year	<u>11,878</u>	<u>\$ 53.20</u>	<u>11,878</u>	<u>\$ 53.20</u>

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:

	<u>2006</u>
Dividend yield	0%
Expected volatility	84.8%
Risk-free interest	4.58%
Contractual life of up to	1 year

In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling \$0 and \$6,563 for the years ended December 31, 2007 and 2006, respectively, and included these amounts in general and administrative expenses.

10. The remaining total compensation cost related to non-vested stock options and restricted share awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2007 was \$2,294,727, of which \$90,457 was for stock options and \$2,204,271 was for restricted shares. The weighted average period over which this compensation cost is expected to be recognized is approximately 2 years.

d. 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.

e. Treasury Stock:

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

NOTE 14:– INCOME TAXES

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

As of December 31, 2007, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$21.2 million, which are available to offset future taxable income, if any, expiring in 2009 through 2027. 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 adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company did not record a liability for unrecognized tax positions. The adoption of FIN 48 did

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

not impact the Company's financial condition, results of operations or cash flows. At December 31, 2007, the Company had net deferred tax assets of \$36.8 million. The deferred tax assets are primarily composed of federal, state and foreign tax net operating loss ("NOL") carryforwards. Due to uncertainties surrounding the Company's ability to generate future taxable income to realize these assets, a full valuation has been established to offset its net deferred tax asset. Additionally, the future utilization of the Company's NOL carryforwards to offset future taxable income is subject to a substantial annual limitation as a result of ownership changes that that has occurred. The Company has completed a Section 382 analysis regarding the limitation of the net operating losses and has determined that the maximum amount of U.S. federal NOL available as of January 1, 2007 was \$18,851,605, compared to the amount shown on the tax return of \$31,161,945. The related DTA and corresponding valuation allowance were reduced by \$4,185,516 for the U.S. federal NOLs and by \$3,555,231 for the state NOLs. The Company has also re-evaluated the unrecognized tax benefits under FIN 48 after the completion of the Section 382 analysis. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in our unrecognized tax benefits will not impact the Company's effective tax rate.

At least three years of the Company's federal returns are still open for examination, so it is possible that the amount of this liability could change in future accounting periods.

The Company files income tax returns, including returns for its subsidiaries, with federal, state, local and foreign jurisdictions. The Company is no longer subject to IRS examination for periods prior to 2003, although carryforward losses that were generated prior to 2002 may still be adjusted by the IRS if they are used in a future period. Additionally, the Company is no longer subject to examination in Israel for periods prior to 2002.

On July 12, 2007, the Governor of Michigan signed into law the Michigan Business Tax (MBT), which will be effective January 1, 2008. This is a combined income tax and modified gross receipts tax and replaces the Michigan Single Business Tax. The Company does not believe that the impact of the MBT on the Company's financial position will be material.

The Company files consolidated tax returns with its U.S. 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 two 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 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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

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 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 reduced tax rates.

3. As stated above for each specific program

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

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 31%.

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, 2007 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, 2007. 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 subsidiaries 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, 2007, 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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

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, Epsilon 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 Epsilon 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, 2007, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$106 million, which are available, indefinitely, to offset future taxable income.

d. 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, 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: 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

e. Deferred income taxes:

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

	December 31,	
	2007	2006
Operating loss carryforward ⁽¹⁾	\$33,741,900	\$33,222,692
Other temporary differences	4,088,598	7,192,079
Net deferred tax asset before valuation allowance	37,830,498	40,414,771
Valuation allowance	(37,752,789)	(40,356,739)
Total deferred tax asset	\$ 77,709	\$ 58,032
Deferred tax liability	\$ 1,020,000	\$ 900,000

(1)

	December 31,	
	2007	2006
Domestic	\$ 7,216,709	\$ 11,627,401
Foreign	26,525,191	21,595,291
	\$ 33,741,900	\$ 33,222,692

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

We have not recorded any deferred taxes on the cumulative undistributed earnings of other non-U.S. subsidiaries because the earnings are intended to be indefinitely re-invested in those operations and we are unable, at this time, to estimate the amount. Accrued income taxes on the undistributed earnings of domestic subsidiaries and affiliates are not provided because dividends received from domestic companies are expected to be non-taxable.

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, 2007 was \$(2,723,950).

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

	Year ended December 31	
	2007	2006
Domestic	\$ 2,464,512	\$ 13,014,325
Foreign	365,711	2,340,082
	<u>\$ 2,830,223</u>	<u>\$ 15,354,407</u>

g. Taxes on income were comprised of the following:

	Year ended December 31	
	2007	2006
Current state and local taxes	\$ 111,162	\$ 225,371
Deferred taxes	100,323	6,788
Taxes in respect of prior years	(47,569)	–
	<u>\$ 163,916</u>	<u>\$ 232,159</u>
Domestic	\$ 189,930	\$ 49,383
Foreign	(26,014)	182,776
	<u>\$ 163,916</u>	<u>\$ 232,159</u>

h. 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:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

	Year ended December 31,	
	2007	2006
Loss from continuing operations before taxes, as reported in the consolidated statements of income	<u><u>\$(2,830,223)</u></u>	<u><u>\$(15,354,407)</u></u>
Statutory tax rate	<u>34%</u>	<u>34%</u>
Theoretical income tax on the above amount at the U.S. statutory tax rate	\$ (962,276)	\$(5,220,498)
Deferred taxes on losses for which valuation allowance was provided	955,412	2,745,964
Non-deductible expenses	126,864	2,793,214
Foreign non-deductible expenses	27,748	–
State taxes	69,930	49,383
Foreign income in tax rates other than U.S. rate	(5,969)	(141,822)
Taxes in respect of prior years	(47,569)	–
Others	<u>(224)</u>	<u>5,918</u>
Actual tax expense	<u><u>\$ 163,916</u></u>	<u><u>\$ 232,159</u></u>

NOTE 15:– SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expenses), net:

	Year ended December 31,	
	2007	2006
Financial expenses:		
Interest, bank charges and fees	\$ (662,789)	\$(2,018,061)
Amortization related to warrants issued to the holders of convertible debentures and benefi- cial conversion feature	(18,745)	(1,485,015)
Expenses in connection with convertible de- benture principle repayment	(280,382)	(5,395,338)
Bonds premium amortization	–	–
Other	(91,625)	(35,332)
Foreign currency translation differences	<u>–</u>	<u>–</u>
	<u>(1,053,540)</u>	<u>(8,933,746)</u>
Financial income:		
Interest	53,298	646,583
Foreign currency translation differences	94,354	67,150
Financial income in connection with warrants granted (Note 12.c. and 13.b.3.)	<u>–</u>	<u>700,113</u>
Total	<u><u>\$ (905,888)</u></u>	<u><u>\$(7,519,900)</u></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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

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: Training and Simulation (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:

	<u>Training and Simulation</u>	<u>Armor</u>	<u>Battery and Power Systems</u>	<u>All Others</u>	<u>Total</u>
2007					
Revenues from outside customers	\$27,760,858	\$ 18,724,107	\$11,234,596	\$ –	\$ 57,719,561
Depreciation , amortization and impairment expenses ⁽¹⁾	(1,667,703)	(469,093)	(1,024,434)	(227,980)	(3,389,210)
Direct expenses ⁽²⁾	(21,610,720)	(17,490,430)	(11,023,839)	(6,355,909)	(56,480,898)
Segment net income (loss)	\$ 4,482,435	\$ 764,584	\$ (813,677)	\$ (6,583,889)	(2,150,547)
Financial expenses	(14,610)	(93,292)	(176,834)	(621,152)	(905,888)
Net income (loss)	\$ 4,467,825	\$ 671,292	\$ (990,511)	\$ (7,205,041)	\$ (3,056,435)
Segment assets ^{(3) (4)}	\$43,810,684	\$11,235,386	\$21,191,545	\$ 4,243,692	\$ 80,481,307
2006					
Revenues from outside customers	\$21,951,337	\$12,571,779	\$8,597,623	\$ –	\$ 43,120,739
Depreciation , amortization and impairment expenses ⁽¹⁾	(1,708,012)	(1,077,416)	(844,431)	(350,308)	(3,980,167)
Direct expenses ⁽²⁾	(18,256,934)	(13,234,826)	(8,768,086)	(6,929,985)	(47,189,831)
Segment net income (loss)	\$ 1,986,391	\$ (1,740,463)	\$ (1,014,894)	\$ (7,280,293)	\$ (8,049,259)
Financial expenses	129,908	(54,476)	50,590	(7,645,922)	(7,519,900)
Net income (loss)	\$ 2,116,299	\$ (1,794,939)	\$ (964,304)	\$ (14,926,215)	\$ (15,569,159)
Segment assets ^{(3) (4)}	\$43,753,369	\$9,523,126	\$18,184,133	\$ 3,607,646	\$ 75,068,274

⁽¹⁾ Includes depreciation of property and equipment, amortization expenses of intangible assets and impairment of goodwill and other intangible assets.

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

⁽³⁾ Consisting of all assets.

⁽⁴⁾ Out of those amounts, goodwill in the Company's Training and Simulation, Battery and Power Systems and Armor Divisions stood at \$24,235,419, \$5,946,649 and \$1,176,063 as of December 31, 2007, and \$24,235,419, \$5,413,210 and \$1,066,596 as of December 31, 2006, respectively.

c. Summary information about geographic areas:

The following presents total revenues according to the location of the end customer for the years ended December 31, 2007 and 2006, and long-lived assets as of December 31, 2007 and 2006:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

	2007		2006	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars			
U.S.A.	\$ 45,198,904	\$3,141,428	\$32,945,951	\$1,916,964
Germany	230,571	–	387,612	–
England	273,239	–	240,712	–
Thailand	–	–	–	–
India	1,153,521	–	1,388,401	–
Israel	8,239,135	1,938,368	5,658,986	1,823,629
Other	2,624,191	–	2,499,077	–
	<u>\$ 57,719,561</u>	<u>\$5,079,796</u>	<u>\$43,120,739</u>	<u>\$3,740,593</u>

d. Revenues from major customers:

	Year ended December 31,	
	2007	2006
Batteries and power systems:		
Customer A	6%	6%
Armor:		
Customer B	6%	5%
Customer C	19%	18%
Training and Simulation:		
Customer D	27%	34%
Customer E	6%	–

e. Revenues from major products:

	Year ended December 31,	
	2007	2006
Water activated batteries	1,629,014	1,660,521
Military batteries	9,605,582	6,937,101
Car and aircraft armoring	18,724,107	12,571,779
Simulators	27,760,858	21,951,338
Total	<u>\$ 57,719,561</u>	<u>\$ 43,120,739</u>

NOTE 17:– ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income consists of currency translation adjustments of \$1,495,000 and \$508,000 and unrealized gains on marketable securities of \$6,000 and \$4,000 at December 31, 2007 and 2006, respectively.

NOTE 18:– WARRANTY

The Company provides or sells a warranty on certain of our simulators and armored vehicles. The Company allocates a percentage of each covered system or a dollar amount per covered vehicle to our warranty reserve. The amount reserved, either percentage or fixed dollar amount is determined using his-

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 18:– WARRANTY (Cont.)

torical repair costs. These calculations along with the amounts allocated are reviewed semi-annually by management.

	<u>Accrued liability beginning of year</u>	<u>New accruals during year</u>	<u>Charges for the year</u>	<u>Accrued liability end of year</u>
2006	(666,541)	(1,513,513)	1,037,053	(1,143,001)
2007	(1,143,001)	(1,310,845)	936,777	(15,17,069)

NOTE 19:– PRIOR PERIOD ADJUSTMENT

The accumulated deficit for January 1, 2006 was increased by \$900,000 to \$143,869,964 to reflect a deferred tax liability that was created when the Company deducted goodwill on previously filed tax returns. This did not have a material impact on the Company's Consolidated Statement of Operations.

NOTE 20:– SUBSEQUENT EVENTS

a. In February 2008 the Company's FAAC subsidiary acquired Realtime Technologies, Inc. (RTI), a privately-owned corporation headquartered in Royal Oak, Michigan, for a total of \$1,350,000 (\$1,250,000 in cash and \$100,000 in stock) with a 2008 earn-out (maximum of \$250,000) based on 2008 net profit.

b. In January 2008, the Company purchased the minority shareholder's in 24.5% interest in MDT Israel and his 12.0% interest in MDT Armor, as well as settling all outstanding disputes regarding severance payments, in exchange for a total of \$1.0 million.

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2007 and 2006

Description	Balance at beginning of period	Additions charged to costs and expenses*	Balance at end of period
Year ended December 31, 2007			
Allowance for doubtful accounts	\$ 159,000	\$ (134,000)	\$ 25,000
Allowance for slow moving inventory	1,573,000	151,000	1,724,000
Valuation allowance for deferred taxes	40,357,000	(2,604,000)	37,753,000
Totals	<u>\$42,089,000</u>	<u>\$(2,587,000)</u>	<u>\$39,502,000</u>
Year ended December 31, 2006			
Allowance for doubtful accounts	\$ 176,000	\$ (17,000)	\$ 159,000
Allowance for slow moving inventory	1,280,000	293,000	1,573,000
Valuation allowance for deferred taxes	34,484,000	5,873,000	40,357,000
Totals	<u>\$35,940,000</u>	<u>\$ 6,149,000</u>	<u>\$42,089,000</u>

*The 2007 and 2006 valuation allowance includes an adjustment to the prior year provision calculation due to changes recognized in the preparation of the actual returns.

AROTECH DIRECTORS

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

Edward J. Borey, Director
Consultant

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

Steven Esses, Director
*President and Chief Operating Officer,
Arotech Corporation*

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

Michael Marrus, Director
*Managing Director,
Collins Stewart LLC*

Elliot Sloyer, Director
*Managing Member,
WestLane Capital Management LLC*

AROTECH CORPORATE OFFICERS

Robert S. Ehrlich
Chairman and Chief Executive Officer

Steven Esses
President and Chief Operating Officer

Dean Krutty
President, Training and Simulation Division

Jonathan Whartman
President, Armor Division

Ronen Badichi
President, Battery and Power Systems Division

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

Thomas J. Paup
Vice President – Finance and CFO

Norman Johnson
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Wednesday, August 13, 2008, at 10:00 a.m. local time at the offices of Lowenstein Sandler P.C., 1251 Avenue of the Americas, 18th Floor, 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.

AROTECH

www.arotech.com

Arotech Corporation

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