

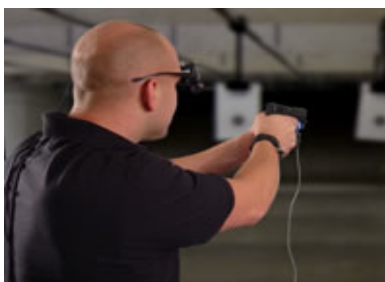
AROTECH

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

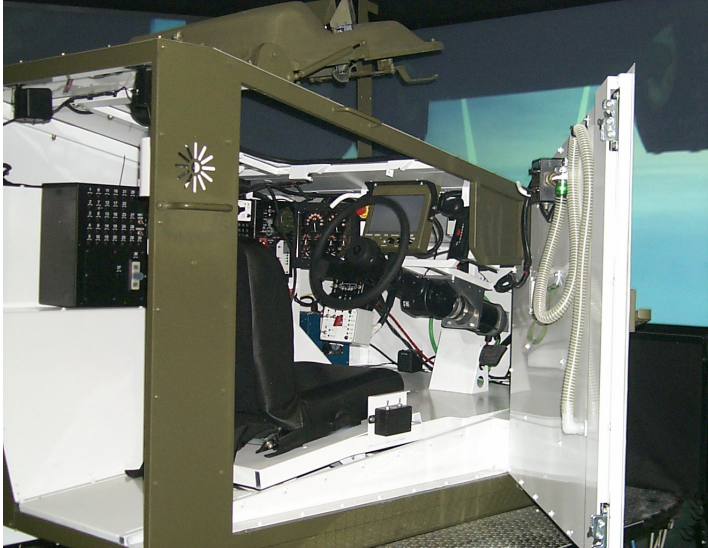
Arotech Corporation

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Nasdaq: ARTX



WE TRAIN WE PROTECT WE SUPPLY



**Training & Simulation
Division**

Armor Division



**Battery & Power
Systems Division**

Arotech Corporation

Annual Report 2008

Nasdaq: ARTX

AROTECH

April 2009

Dear Fellow Shareholder,

Arotech Corporation's 2008 was a year of significant milestones in a challenging economic environment. Revenues in 2008 turned out to be the best ever for our company. In the recent past we have worked to establish a stable foundation for growth within the company and within our divisions, and we are hopeful that this foundation will enable us to continue to do well even in today's difficult economic environment. Our commitment to building shareholder value remains a principal objective as we continue to put together a base of new products, services and customers that we believe will enable us to achieve our growth goals.

We are also working to achieve a higher level of transparency on our business model so that the public markets can more appropriately value our long-term business prospects. We strongly believe that the total value of our divisions is considerably more than what the public market price reflects for Arotech as a whole.

Simulation continues to be our strongest division and demonstrates continuing growth. Notable developments included a CDT Mobile Training Facility award of \$12.8 million, of which \$5.1 million was delivered in 2008 with the balance to be delivered in 2009. We also were awarded a USMC ODS contract extension of \$4 million in new system funding, bringing the total of that program to \$26 million and important new opportunities for FAAC and IES in Asia.

In the Battery Division, 2008 revenues, margins and EBITDA all surpassed expectations, with the division having its best year ever, while operating on a cash-flow positive basis despite a difficult first half. Noteworthy achievements were Epsilon being selected as the supplier of \$2 million in batteries and chargers to be supplied by the end of 2009 to an army in Asia, with an option for an additional similar order in 2010, and the development for EI Op of a thermal imaging system. A new marketing manager was employed in the U.S., which we anticipate will provide us with more U.S. opportunities.

Our Armor Division recovered somewhat in the second half but it remains a challenging situation because of a lack of new orders in the pipeline. Second half results were significantly better than first half and allowed the division to record a reasonable EBITDA. We are continuing to deliver the remaining order of "David"s on time from both sites and aviation armor sales have been satisfactory. Our India joint venture continues to move forward and we are cautiously optimistic of receiving first orders for 2010 delivery.

On the corporate front we continue to cut costs wherever we can in order to improve financial results.

The outlook for 2009 appears reasonable despite the difficult economic environment, led by a good outlook in our simulation and battery divisions. We must note, however, that the tough economy could have some impact as yet unanticipated.

Sincerely,

A handwritten signature in black ink, appearing to read "R. Ehrlich", with a horizontal line extending to the right.

Robert S. Ehrlich
Chairman and Chief Executive Officer

The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on April 10, 2009.

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 personal and 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 vehicles 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, marine armor and specialized personal armor through our subsidiary Armour of America, located in Auburn, Alabama,

which we merged into our MDT Armor subsidiary in June of 2008 ("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 lifejacket 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, FAAC, RTI, and MDT Armor. Additionally, we operate under the trade names of IES Interactive (IES) and Armour of America (AoA).

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 Epsilon, 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 FAAC's subsidiary, Realtime Technologies, are located in Royal Oak, Michigan. The 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 2008 and 2007, revenues from our Training and Simulation Division were approximately \$36.0 million and \$27.8 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 and Realtime Technologies nameplates; 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 2008, our Vehicle Simulations group accounted for approximately 68% 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.

In January of 2008 we added Realtime Technologies Incorporated to our Vehicle Simulation group. RTI specializes in multi-body vehicle dynamics modeling and graphical simulation solutions. RTI offers simulation software applications, consulting services, and custom software and hardware development services primarily for use by the automobile industry and universities engaged in the study of vehicle performance or operator/vehicle interactions.

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 in-

dustrial 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 2008, our Military Operations group accounted for 18% 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 and market our interactive training products, such as the MILO (Multiple Interactive Learning/training Objectives) System, the A2Z Classroom Trainer (a state-of-the-art Computer Based Training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom), and the Range FDU (firearm diagnostics unit), using our IES Interactive Training nameplate. In 2008, our Use of Force group accounted for 14% 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 over 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. Dur-

ing 2008 and 2007, revenues from our Armor Division were approximately \$17.7 million and \$18.7 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 interest in 2002 and the remaining minority interest early in 2008), 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, merging it into MDT Armor in June 2008.

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. We are also actively exploring marketing armor products in India, through Concord Safety Solutions Pvt. Ltd., an Indian company that we own in equal thirds with an Indian vehicle company and an Indian armoring company.

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 \$25.0 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. We did not receive any David orders in 2008.

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 2008 and 2007, revenues from our Battery and Power Systems Division were approximately \$15.2 million and \$11.2 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 bat-

teries 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 2008 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 (LiSO₂) cells. The largest suppliers of LiSO₂ 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 (LiMnO₂) cells. Suppliers of LiMnO₂ 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

EFB 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, 2008 and 2007, our backlog for the following years was approximately \$36.6 million and \$48.7 million, respectively, divided among our divisions as follows:

Division	2008	2007
Training and Simulation Division.....	\$ 16,503,000	\$ 21,670,000
Armor Division	7,874,000	14,164,000
Battery and Power Systems Division...	12,226,000	12,861,000
TOTAL:	\$ 36,603,000	\$ 48,695,000

Major Customers

During 2008 and 2007, including all of our divisions, various branches of the United States military accounted for approximately 54% and 52% of our revenues.

Price Range of Common Stock

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

Year Ended December 31, 2008	High	Low
Fourth Quarter	\$ 1.13	\$ 0.39
Third Quarter	\$ 2.07	\$ 1.02
Second Quarter.....	\$ 2.70	\$ 2.00
First Quarter.....	\$ 2.73	\$ 1.66
Year Ended December 31, 2007	High	Low
Fourth Quarter	\$ 3.63	\$ 1.94
Third Quarter	\$ 3.70	\$ 2.52
Second Quarter.....	\$ 3.73	\$ 2.15
First Quarter.....	\$ 4.87	\$ 3.03

As of February 28, 2009 we had approximately 324 holders of record of our common stock.

Dividends

We have never paid any cash dividends on our common stock. The Board of Directors presently intends to retain all earnings for use in our business. Any future determination as to payment of dividends will depend upon our financial condition and results of operations and such other factors as the Board of Directors deems relevant. Additionally, our ability to declare dividends should we decide to do so is restricted by the terms of our debt agreements.

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, stock compensation,

taxes, 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 collec-

tion 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.

We have indefinitely-lived intangible assets consisting of trademarks, workforce, and goodwill. Pursuant to SFAS No. 142, "Goodwill and Other Intangible Assets," these indefinitely-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these indefinitely-lived intangible assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a "naked tax credit." This deferred tax liability could remain on our balance sheet indefinitely unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

Due to the fact that the aforementioned deferred tax liability could have an indefinite life, it should not be netted against our deferred tax assets (which primarily relate to net operating loss carryforwards) when determining the required valuation allowance. Doing so would result in the understatement of the valuation allowance and related deferred income tax expense.

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 position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. 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.

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 2008, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

As of December 31, 2008, we had recorded goodwill of \$32.3 million. Under Financial Accounting Standards Board Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests, and tests between annual tests in certain circumstances, based on estimated fair value in accordance with SFAS 142, and written down when impaired.

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. 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. 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.

We completed our annual goodwill impairment review at the end of the quarter ended June 30, 2008. Although the cumulative book value of our reporting units exceeded our market value as of the impairment review, management nevertheless determined that the fair value of the respective reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill. Several factors contributed to this determination:

- The long term horizon of the valuation process versus a short term valuation using current market conditions;

- The valuation by individual business segments versus the market share value based on our company as a whole; and
- The fact that our stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in our securities was not acting as an informationally efficient reflection of all known information regarding us. The fact that our stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in our securities was not acting as an informationally efficient reflection of all known information regarding us.

In view of the above factors, management felt that in the current market as of June 30, 2008, our stock was undervalued, especially when compared to the estimated future cash flows of the underlying entities.

Due to the extreme volatility in the stock market and the effect on our common stock price during the year ended December 31, 2008, we decided to update the goodwill impairment studies originally conducted as of June 30, 2008. Because of current market conditions and overall depressed stock values, we used the discounted future cash flow method in an effort to determine more accurately the true value of us and our subsidiaries. We based the determination on our belief that our stock price had historically traded at a much higher value and that the current stock price and resultant market capitalization amount are a short term condition. We concluded that the collective value of its individual business units on a longer term horizon exceeds the value of the short term market assessment of our common stock.

The results of the updated assessments confirmed the previously conducted studies as of June 30, 2008 that there is no impairment of goodwill as of December 31, 2008.

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

Executive Summary

Overview of Results of Operations

We incurred operating losses for the years ended December 31, 2008 and 2007. 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 2008 and 2007 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 2009, 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 2008. 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 2008 and 2007 in the amount of \$1.7 million and \$1.4 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 2008 and 2007, we issued restricted shares to certain of our employees and to our directors. These shares were issued as stock bonuses or were the required annual grant to directors, 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 2008

and 2007 in the amount of \$1.0 million and \$1.3 million, 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 2008 and 2007 in the amount of \$68,000 and \$86,000, respectively.

Under the terms of our convertible notes that we had issued in 2005, which have since 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%.

During 2007, we converted the remaining \$6,976,097 of principal remaining outstanding under our secured 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 warrants 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.

Pursuant to the terms of a securities purchase agreement dated August 14, 2008, we issued and sold to a group of institutional investors 10% senior convertible notes in the aggregate principal amount of \$5.0 million due August 15, 2011. These notes are convertible at any time prior to August 15, 2011 at a conversion price of \$2.24 per share. As part of our analysis of the convertible debt and related warrants, we reviewed and followed the guidance of SFAS No. 150 and EITF Issues No. 00-19, 00-27 and 05-2.

As part of the securities purchase agreement, we issued to the purchasers of our 10% senior convertible notes due August 15, 2011, warrants to purchase an aggregate of 558,036 shares of common stock at any time prior to Au-

gust 15, 2011 at a price of \$2.24 per share. The warrants were classified as equity based on relative fair value.

The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.78%, a volatility factor 75%, dividend yields of 0% and a contractual life of 3.0 years.

In connection with these convertible notes, we recorded a deferred debt discount of \$412,000 arising from the 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 – August 15, 2011 – or to the actual conversion date, if earlier, as financial expenses using the effective interest method.

Principle payments are due on the convertible notes as follows:

Year	Amount
2009	\$ 1,818,180
2010	1,818,180
2011	1,363,640
	<u>\$ 5,000,000</u>

Concurrent with the Securities Purchase Agreement dated August 14, 2008, we purchased a \$2,500,000 Senior Subordinated Convertible Note from an unaffiliated company, DEI Services Corporation. This 10% Senior Subordinated Convertible Note is due December 31, 2009. The note is convertible at maturity at our option into such number of shares of DEI's common stock, no par value per share, as shall be equal at the time of conversion to twelve percent (12%) of DEI's outstanding common stock.

Interest on the outstanding principal amount of this note commenced accruing on the issuance date and is payable quarterly, in arrears, on November 15, February 15, May 15 and August 15 of each year with the first payment due November 15, 2008.

Results of Operations

Preliminary Note

SUMMARY

Following is a table summarizing our results of operations for the years ended December 31, 2008 and 2007, after which we present a narrative discussion and analysis:

Interest on this note will be recognized as a reduction of financial expenses and will be shown on an accrual basis. Related fees and costs will be recorded as general and administrative expense.

During 2008 and 2007, we recorded expenses of \$52,000 and \$19,000, respectively, attributable to amortization related to warrants issued to the holders of convertible notes. During 2007, we also recorded expenses of \$280,000, attributable to financial expenses in connection with convertible note principle repayment. Additionally, during 2007, we recorded expenses of \$44,000, attributable to amortization of deferred charges related to debt discount resulting from the warrants that were issued in 2008.

Overview of Operating Performance and Backlog

Overall, our net loss before minority interest earnings, earnings from an affiliated company and tax expenses for 2008 was \$2.4 million on revenues of \$68.9 million, compared to a net loss of \$2.8 million on revenues of \$57.7 million during 2007. As of December 31, 2008, our overall backlog totaled \$36.6 million.

In our Training and Simulation Division, revenues increased from approximately \$27.8 million in 2007 to \$36.0 million in 2008. As of December 31, 2008, our backlog for our Training and Simulation Division totaled \$16.5 million.

In our Armor Division, revenues decreased from approximately \$18.7 million in 2007 to approximately \$17.7 million in 2008. As of December 31, 2008, our backlog for our Armor Division totaled \$7.9 million.

In our Battery and Power Systems Division, revenues increased from approximately \$11.2 million in 2007 to approximately \$15.2 million in 2008. As of December 31, 2008, our backlog for our Battery and Power Systems Division totaled \$12.2 million.

	Year Ended December 31,	
	2008	2007
		(as restated; see Note 19 to Consolidated Financial Statements)
Revenues:		
Training and Simulation Division	\$ 36,032,703	\$ 27,760,858
Armor Division	17,762,439	18,724,107
Battery and Power Systems Division	15,153,827	11,234,596
	<u>\$ 68,948,969</u>	<u>\$ 57,719,561</u>
Cost of revenues:		
Training and Simulation Division	\$ 22,017,653	\$ 15,528,023
Armor Division	15,932,478	15,906,071
Battery and Power Systems Division	12,227,778	8,205,718
	<u>\$ 50,177,909</u>	<u>\$ 39,639,812</u>
Research and development expenses:		
Training and Simulation Division	\$ 797,112	\$ 629,430
Armor Division	247,462	115,500
Battery and Power Systems Division	613,094	1,132,233
	<u>\$ 1,657,668</u>	<u>\$ 1,877,163</u>
Sales and marketing expenses:		
Training and Simulation Division	\$ 3,232,367	\$ 2,956,995
Armor Division	754,645	634,237
Battery and Power Systems Division	712,858	570,768
All Other	—	2,464
	<u>\$ 4,699,870</u>	<u>\$ 4,164,464</u>
General and administrative expenses:		
Training and Simulation Division	\$ 4,068,614	\$ 3,400,013
Armor Division	1,590,549	1,295,079
Battery and Power Systems Division	1,239,288	1,658,968
All Other	7,195,313	6,804,237
	<u>\$ 14,093,764</u>	<u>\$ 13,158,297</u>
Escrow Adjustment:		
All Other	\$ (1,448,074)	\$ —
	<u>\$ (1,448,074)</u>	<u>\$ —</u>
Other income:		
Training and Simulation Division	\$ 34,714	\$ 122,934
Armor Division	63,099	152,206
Battery and Power Systems Division	27	—
All Other	325,043	342,812
	<u>\$ 422,883</u>	<u>\$ 617,952</u>
Financial expense:		
Training and Simulation Division	\$ 195	\$ 14,610
Armor Division	357,517	93,292
Battery and Power Systems Division	313,671	176,834
All Other	142,706	621,152
	<u>\$ 814,089</u>	<u>\$ 905,888</u>
Tax expenses (credits):		
Training and Simulation Division	\$ 68,608	\$ 69,930
Armor Division	58,147	2,639
Battery and Power Systems Division	100,113	(28,653)
All Other	800,000	565,000
	<u>\$ 1,026,868</u>	<u>\$ 608,916</u>
Amortization of intangible assets:		
Training and Simulation Division	\$ 1,212,958	\$ 776,736
Armor Division	13,350	95,907
Battery and Power Systems Division	509,240	509,239
	<u>\$ 1,735,548</u>	<u>\$ 1,381,882</u>
Loss from affiliated company:		
Training and Simulation Division	\$ (352,166)	\$ (40,230)
Armor Division	(100,000)	—
	<u>\$ (452,166)</u>	<u>\$ (40,230)</u>
Minority interest in profit of subsidiaries:		
Armor Division	\$ —	\$ (62,296)
	<u>\$ —</u>	<u>\$ (62,296)</u>
Net income (loss):		
Training and Simulation Division	\$ 4,317,744	\$ 4,467,825
Armor Division	(1,228,610)	671,292
Battery and Power Systems Division	(562,188)	(990,511)
All Other	(6,364,902)	(7,650,041)
	<u>\$ (3,837,956)</u>	<u>\$ (3,501,435)</u>

Fiscal Year 2008 compared to Fiscal Year 2007 (as restated)

Revenues. During 2008, we (through our subsidiaries) recognized revenues as follows:

- FAAC, IES and RTI recognized revenues from the sale of military operations and vehicle simulators, 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 Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military and commercial customers, 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 2008 totaled \$68.9 million, compared to \$57.7 million in 2007, an increase of \$11.2 million, or 19.5%. This increase was primarily attributable to the following factors:

- Increased revenues from our Training and Simulation Division (\$8.2 million more in 2008 versus 2007), which includes \$2.6 million in revenues from our newly acquired subsidiary RTI and an increase of approximately \$5.0 million in sales of military vehicle simulators.
- Increased revenues from our Battery and Power Systems Division (\$4.0 million more in 2008 versus 2007), primarily due to increased military and commercial battery sales at Epsilor.

These increases were offset to some extent by decreased revenues from our Armor Division (\$1.0 million less in 2008 versus 2007).

In 2008, revenues were \$36.0 million for the Training and Simulation Division (compared to \$27.8 million in 2007, an increase of \$8.2 million, or 29.8%, due primarily to increased sales of military operations and vehicle simulators); \$15.2 million for the Battery and Power Systems Division (compared to \$11.2 million in 2007, an increase of \$4.0 million, or 34.9%, due primarily to increased sales of our battery products at Ep-

silor); and \$17.7 million for the Armor Division (compared to \$18.7 million in 2007, a decrease of \$1.0 million, or 5.1%, due primarily to decreased revenues from MDT and MDT Armor, mostly in respect of orders for the "David" Armored Vehicle).

Cost of revenues. Cost of revenues totaled \$50.2 million during 2008, compared to \$39.6 million in 2007, an increase of \$10.6 million, or 26.6%, due primarily to increased sales in our Training and Simulation and our Battery and Power Systems Divisions. Total cost of revenues and cost of revenues as a percentage of revenue also increased in each division due to several factors, including price increases in raw materials, increased labor costs and the production of new products.

Cost of revenues for our three divisions during 2008 were \$22.0 million for the Training and Simulation Division (compared to \$15.5 million in 2007, an increase of \$6.5 million, or 41.8%, due primarily to increased revenues and a product mix that resulted in slightly lower margins); \$12.2 million for the Battery and Power Systems Division (compared to \$8.2 million in 2007, an increase of \$4.0 million, or 49.0%, due primarily to increased revenues and price increases in raw materials along with increased labor costs); and \$15.9 million for the Armor Division (compared to \$15.9 million in 2007, unchanged, due primarily to increased material and labor costs offset by the reduced production of the "David" Armored Vehicle).

Amortization of intangible assets. Amortization of intangible assets totaled \$1.7 million in 2008, compared to \$1.4 million in 2007, an increase of \$354,000, or 25.6%, due primarily to increase in intangibles relating to our purchases of RTI and the minority interest of MDT along with an increase in capitalized technology.

Research and development expenses. Research and development expenses for 2008 were \$1.7 million, compared to \$1.9 million during 2007, a decrease of \$219,000, or 11.7%, due primarily to increased costs at FAAC for expenses associated with the improvements to our simulator products, an increase in costs in our Armor division for expenses associated with improvements to our armoring products along with development expenses associated with our Concord Safety Solutions joint venture in India

offset by a significant reduction of expenses in our Battery division.

Selling and marketing expenses. Selling and marketing expenses for 2008 were \$4.7 million, compared to \$4.2 million 2007, an increase of \$535,000, or 12.9%. Expenses increased in each division and this increase was primarily attributable to the overall increase in revenues and their associated sales and marketing expenses.

General and administrative expenses. General and administrative expenses for 2008 were \$14.1 million, compared to \$13.2 million in 2007, an increase of \$935,000, or 7.1%. This increase was primarily attributable to the charges relating to acquisition transaction costs of \$435,000 that were expensed in 2008 and increased costs associated with the addition of RTI, including a \$250,000 payment of an earnout as required under the terms of the agreement pursuant to which we purchased RTI, offset by reduced stock compensation expenses and reduced legal expenses.

Escrow adjustment. On March 20, 2007, the Company filed a Demand for Arbitration with the American Arbitration Association against the Seller. In February 2008, the arbitration panel issued a decision denying the Seller's counterclaims, granting the Seller's counterclaim for \$70,000 in compensation, awarding the Company the entire \$3.0 million, along with \$135,000 in attorneys' fees and interest of approximately \$325,000. The net impact of the settlement was approximately \$1.8 million, which included an escrow adjustment in the first quarter 2008 of \$1.4 million and approximately \$398,000 in interest and net legal fees. This award was paid to the Company in April 2008.

Financial expenses, net. Financial expenses totaled approximately \$814,000 in 2008 compared to \$906,000 in 2007, a decrease of \$92,000, or 10.1%. The difference was due primarily to reduced interest expenses.

Loss from affiliated company. The investment in the Center for Transportation Safety Inc. and the investment in Concord Safety Solutions Pvt. Ltd were reduced by an aggregate of \$452,000 in 2008.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2008 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 2008, we were able to off-

set federal taxes against our accumulated loss carry forward. We recorded a total of \$1.0 million in tax expenses in 2008, compared to \$609,000 in tax expenses in 2007, mainly due to state and local taxes along with the required adjustment of taxes due to the deduction of goodwill for U.S. federal taxes, which totaled \$565,000 in both 2007 and 2008.

Net loss. Due to the factors cited above, net loss increased to \$3.8 million in 2008 from \$3.5 million in 2007, a difference of \$337,000, or 9.6%.

Liquidity and Capital Resources

As of December 31, 2008, we had \$4.3 million in cash, \$382,000 in restricted collateral securities and \$49,000 in available-for-sale marketable securities, as compared to at December 31, 2007, when 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. We also had \$3.1 million available in unused bank lines of credit with our main bank, under a \$7.5 million credit facility under our FAAC subsidiary, which is secured by our assets and the assets of our other subsidiaries and guaranteed by us. The entire amount of the remaining \$3.1 million of credit on the primary line was available at year end.

We used available funds in 2008 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets by \$1.2 million during the year ended December 31, 2008. Our net fixed assets amounted to \$5.1 million as at year end.

Net cash used in operating activities for 2008 was \$(677,000) and net cash provided by operating activities for 2007 was \$923,000, an increase of \$1.6 million. This increase in cash used was primarily the result of changes in working capital.

Net cash used in investing activities for 2008 and 2007 was \$2.3 million and \$1.6 million, respectively, an increase of \$778,000. This increase was primarily the result of the purchase of \$2.5 million in convertible notes, the acquisition of RTI and the purchase of the minority interest in MDT, offset by the escrow payment from the judgment in the AoA arbitration.

Net cash provided by financing activities for 2008 and 2007 was \$3.9 million and \$1.6 million,

respectively, an increase of \$2.3 million. This increase was primarily due to the new senior notes offset by the change in short-term bank debt.

As of December 31, 2008, 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 \$3.6 million in bank debt and \$5.1 million in long term senior subordinated notes 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.

Over the long term, we will need to be 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, 2008 and 2007, and accordingly no

provision for income taxes was required. With respect to some of our U.S. subsidiaries that operated at a net profit during 2008, we were able to offset federal taxes against our net operating loss carryforward, which amounted to approximately \$35.0 million as of December 31, 2008. 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 2008, 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 27% in 2008 (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, 2008, we had a U.S. net operating loss carryforward of approximately \$24.9 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, 2008, 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	\$ 6,072,775	\$ 1,845,285	\$ 3,242,967	\$ 71,710	\$ 912,813
Short-term debt	\$ 3,607,890	\$ 3,607,890	\$ —	\$ —	\$ —
Operating lease obligations**	\$ 3,916,964	\$ 724,821	\$ 1,028,113	\$ 859,614	\$ 1,304,416
Capital lease obligations	\$ 234,166	\$ 85,394	\$ 111,908	\$ 36,864	\$ —
Severance obligations	\$ 5,161,448	\$ —	\$ 5,161,448	\$ —	\$ —

* 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).

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2008, our management, including the principal executive officer and principal financial officer, evaluated our disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in our periodic reports that we file with the SEC. These disclosure controls and procedures are intended to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers, by other of our employees, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Any system of controls and procedures, no matter how well designed and operated, can at best provide only reasonable assurance that the objectives of the system are met and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met.

Based on their evaluation as of December 31, 2008, 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.

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, 2008. 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, 2008.

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, 2008 and 2007 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 schedule 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 at December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 19 to the financial statements, the 2007 financial statements have been restated to correct a misstatement related to a deferred tax liability.

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 7, 2009

/s/ BDO Seidman, LLP
BDO Seidman, LLP

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2008	2007 (as restated; see Note 19)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 4,301,359	\$ 3,447,671
Restricted collateral deposits.....	381,586	320,454
Escrow receivable.....	—	1,479,826
Available for sale marketable securities.....	49,204	47,005
Trade receivables (net of allowance for doubtful accounts in the amounts of \$19,000 and \$25,000 as of December 31, 2008 and 2007, respectively)	19,346,084	14,583,213
Unbilled receivables	4,769,264	3,271,594
Other accounts receivable and prepaid expenses.....	3,625,955	1,614,614
Inventories	9,678,960	7,887,820
Total current assets.....	42,152,412	32,652,197
DEFERRED TAX ASSET	72,114	77,709
SEVERANCE PAY FUND	2,888,867	2,815,040
OTHER LONG-TERM RECEIVABLES	463,780	309,190
PROPERTY AND EQUIPMENT, NET	5,058,263	5,079,796
INVESTMENT IN AFFILIATED COMPANY	40,987	352,168
OTHER INTANGIBLE ASSETS, NET	6,867,873	7,837,076
GOODWILL.....	32,250,503	31,358,131
Total long term assets	47,642,387	47,829,110
Total Assets	\$ 89,794,799	\$ 80,481,307

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,	
	2008	2007
		(as restated; see Note 19)
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 9,664,558	\$ 4,233,288
Other accounts payable and accrued expenses	5,858,959	4,889,729
Current portion of capitalized leases	62,833	67,543
Current portion of promissory notes due to purchase of subsidiaries	—	151,450
Current portion of long term debt	1,861,187	103,844
Short term bank credit	3,607,890	4,557,890
Deferred revenues	3,789,020	2,903,166
Total current liabilities	24,844,447	16,906,910
LONG TERM LIABILITIES		
Accrued severance pay	5,161,448	4,853,231
Long term portion of capitalized leases	122,090	86,989
Long term debt	3,866,727	1,088,498
Deferred tax liability	2,430,000	1,865,000
Other long term liabilities	146,738	110,255
Total long-term liabilities	11,727,003	8,003,973
COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)		
MINORITY INTEREST	—	83,816
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – \$0.01 par value each;		
Authorized: 250,000,000 shares as of December 31, 2008 and		
2007; Issued and Outstanding: 13,637,639 shares and		
13,544,819 shares as of December 31, 2008 and 2007, respec-		
tively	136,377	135,448
Preferred shares – \$0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2008 and		
2007; No shares issued and outstanding as of December 31,		
2008 and 2007	—	—
Additional paid-in capital	220,124,075	218,551,110
Accumulated deficit	(167,205,514)	(163,367,558)
Notes receivable from shareholder	(1,357,788)	(1,333,833)
Accumulated other comprehensive income	1,526,199	1,501,441
Total stockholders' equity	53,223,349	55,486,608
	<u>\$ 89,794,799</u>	<u>\$ 80,481,307</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

	2008	2007
		(as restated; see Note 19)
Revenues.....	\$ 68,948,969	\$57,719,561
Cost of revenues, exclusive of amortization of intangibles.....	50,177,909	39,639,812
Research and development.....	1,657,668	1,877,163
Selling and marketing expenses	4,699,870	4,164,464
General and administrative expenses	14,093,764	13,158,297
Amortization of intangible assets	1,735,548	1,381,882
Escrow adjustment.....	(1,448,074)	—
 Total operating costs and expenses	 70,916,685	 60,221,618
Operating loss.....	(1,967,716)	(2,502,057)
Other income	422,883	617,952
Financial expenses, net.....	(814,089)	(905,888)
 Loss before minority interest in earnings of a subsidiaries, earnings from affili- ated company, and income tax expenses	 (2,358,922)	 (2,789,993)
Income taxes.....	(1,026,868)	(608,916)
Losses from affiliated companies.....	(452,166)	(40,230)
Minority interest in earnings of subsidiaries.....	—	(62,296)
Net loss.....	<u>\$ (3,837,956)</u>	<u>\$(3,501,435)</u>
 Basic and diluted net loss per share	 <u>\$ (0.30)</u>	 <u>\$ (0.31)</u>
 Weighted average number of shares used in computing basic and diluted net loss per share	 <u>12,605,786</u>	 <u>11,274,387</u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (as restated; see Note 19)

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									
as previously reported	12,023,242	\$ 120,232	\$217,735,860	\$(159,466,123)	\$(3,537,106)	\$ (1,304,179)	\$ 511,154	\$ -	\$ 54,059,838
Prior period adjustment	-	-	-	(400,000)	-	-	-	-	(400,000)
Balance as of January 1, 2007, as adjusted	12,023,242	\$ 120,232	\$217,735,860	\$(159,866,123)	\$(3,537,106)	\$ (1,304,179)	\$ 511,154	\$ -	\$ 53,659,838
Principal installment of con- vertible 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 re- ceivable from shareholders ..	-	-	29,654	-	-	(29,654)	-	-	-
Other comprehensive loss – foreign currency translation adjustment	-	-	-	-	-	-	988,740	988,740	988,740
Other comprehensive loss – un- realized gain on available for sale marketable securities	-	-	-	-	-	-	1,547	1,547	1,547
Net loss as restated	-	-	-	(3,501,435)	-	-	-	(3,501,435)	(3,501,435)
Total comprehensive loss as restated	-	-	-	-	-	-	-	\$ (2,511,148)	-
Balance as of December 31, 2007 as restated	13,544,819	\$ 135,448	\$218,551,110	\$(163,367,558)	\$ -	\$ (1,333,833)	\$1,501,441		\$ 55,486,608

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	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
	Shares	Amount						
Balance as of January 1, 2008.....	13,544,819	\$ 135,448	\$218,551,110	\$ (163,367,558)	\$ (1,333,833)	\$1,501,441	\$	\$ 55,486,608
Issuance of warrants.....	—	—	412,300	—	—	—	—	412,300
Stock based compensation	—	—	1,039,270	—	—	—	—	1,039,270
Stock options and restricted stock	38,472	385	(385)	—	—	—	—	—
Issuance of stock for acquisition	54,348	544	97,825	—	—	—	—	98,369
Interest accrued on notes receivable from shareholders...	—	—	23,955	—	(23,955)	—	—	—
Other comprehensive loss – foreign currency translation adjustment.....	—	—	—	—	—	23,103	23,103	23,103
Other comprehensive loss – unrealized gain on available for sale marketable securities.....	—	—	—	—	—	1,655	1,655	1,655
Net loss.....	—	—	—	(3,837,956)	—	—	(3,837,956)	(3,837,956)
Total comprehensive loss.....	—	—	—	—	—	—	\$ (3,813,198)	—
Balance as of December 31, 2008.....	13,637,639	\$ 136,377	\$220,124,075	\$ (167,205,514)	\$ (1,357,788)	\$1,526,199		\$ 53,223,349

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

	<u>2008</u>	<u>2007</u>
		(as restated; see Note 19)
Cash flows from operating activities:		
Net loss.....	\$ (3,837,956)	\$ (3,501,435)
Adjustments required to reconcile net loss to net cash used in operating activities:		
Minority interest in loss of subsidiary.....	—	62,296
Loss from affiliated companies	452,168	40,230
Depreciation.....	1,246,238	1,376,749
Amortization of intangible assets and capitalized software costs	1,735,548	1,381,822
Escrow adjustment	(1,845,977)	—
Accrued severance pay, net	234,390	245,599
Compensation related to shares issued to employees, consultants and directors.....	1,039,270	1,417,521
Financial expenses in connection with convertible debenture principle repayment ...	—	280,382
Amortization related to warrants issued to the holders of convertible debentures and beneficial conversion feature	—	18,745
Amortization of deferred charges related to convertible debentures issuance	—	44,253
Amortization of debt discount.....	51,537	—
Capital gain (loss) from sale of property and equipment.....	(11,379)	56,224
Increase in trade receivables.....	(4,570,057)	(6,802,248)
Decrease (increase) in other accounts receivable and prepaid expenses.....	234,402	(706,569)
Decrease in deferred taxes.....	570,595	545,323
Increase in inventories.....	(1,760,946)	(36,000)
Decrease (increase) in unbilled receivables	(1,432,369)	3,630,939
Increase in deferred revenues	885,854	1,581,854
Increase in trade payables.....	5,420,310	1,425,156
Increase (decrease) in other accounts payable and accrued expenses	911,112	(137,834)
Net cash provided by (used in) operating activities.....	\$ (677,260)	\$ 923,007
Cash flows from investing activities:		
Purchase of property and equipment	(1,191,822)	(1,594,426)
Purchase of convertible notes.....	(2,500,000)	—
Increase in capitalized software costs	—	(15,750)
Proceeds from escrow settlement.....	3,325,803	—
Acquisition of subsidiary, net of cash acquired.....	(1,037,884)	—
Acquisition of minority interest	(660,500)	—
Investment in affiliated company	(140,987)	—
Repayment of promissory notes related to acquisition of subsidiaries	(151,450)	(302,900)
Proceeds from sale of property and equipment.....	87,521	36,061
Decrease (increase) in restricted cash	(63,331)	322,682
Net cash used in investing activities.....	\$ (2,332,650)	\$ (1,554,333)

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

	<u>2008</u>	<u>2007</u>
		(as restated; see Note 19)
Forward	\$ (3,009,910)	\$ (631,326)
Cash flows from financing activities:		
Proceeds from exercise of options	—	37,642
Repayment of long term loans	(166,165)	549,874
Increase (decrease) in short term bank credit	(950,000)	1,061,883
Increase in long term debt	5,000,000	—
Net cash provided by financing activities	<u>\$ 3,883,835</u>	<u>\$ 1,649,399</u>
Increase in cash and cash equivalents	873,925	1,018,073
Cash accretion (erosion) due to exchange rate differences	(20,237)	60,726
Cash and cash equivalents at the beginning of the year	3,447,671	2,368,872
Cash and cash equivalents at the end of the year	<u>\$ 4,301,359</u>	<u>\$ 3,447,671</u>
Supplementary information on non-cash and other transactions:		
Stock issued for acquisition	\$ 100,000	\$ —
Assets recorded for capital lease addition	\$ 106,029	\$ —
Mortgage note payable (seller financed) issued for purchase of building	\$ —	\$ 1,115,000
Interest paid during the period	\$ 455,051	\$ 662,789
Taxes on income paid during the period	\$ 333,144	\$ 298,109
Relative fair value of warrants issued in connections with convertible note	\$ 412,300	\$ —
Payment of principal installment of convertible debentures in shares	\$ —	\$ 2,882,753

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 wholly-owned subsidiaries provide defense and security products for the military, law enforcement and homeland security markets, including advanced zinc-air and lithium batteries and chargers, multimedia interactive simulators/trainers and lightweight vehicle armoring. The Company operates primarily through its wholly-owned subsidiaries FAAC Corporation (“FAAC”), based in Ann Arbor, Michigan, and FAAC’s subsidiary Realtime Technologies, Inc. (“Realtime”), which is based in Royal Oak, Michigan; Electric Fuel Battery Corporation (“EFB”), based in Auburn, Alabama; Electric Fuel Ltd. (“EFL”), based in Beit Shemesh, Israel; Epsilor Electronic Industries, Ltd. (“Epsilor”), based in Dimona, Israel; MDT Protective Industries, Ltd. (“MDT”), based in Lod, Israel; and MDT Armor Corporation (“MDT Armor”), based in Auburn, Alabama.

Revenues derived from the Company’s largest customers in 2008 and 2007 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. The \$151,450 shown as promissory notes in the 2007 balance sheet is the portion of the 2006 earnout that was paid in equal installments that started in January 2007 and was fully paid 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. In connection with the Company’s acquisition of AoA, the Company had a contingent earnout obligation in an amount equal to the revenues AoA realized from certain specific programs that were identified by the Company and the seller of AoA (“Seller”) as appropriate targets for revenue increases. As of December 31, 2006, the Company had reduced the \$3.0 million escrow held by the Seller by approximately \$1,520,000 for a putative claim against such escrow in respect of such earnout obligation.

On March 20, 2007, the Company filed a Demand for Arbitration with the American Arbitration Association against the Seller. In February 2008, the arbitration panel issued a decision denying the Seller’s counterclaims, granting the Seller’s counterclaim for \$70,000 in compensation, awarding the Company the entire \$3.0 million, along with \$135,000 in attorneys’ fees and interest of approximately \$325,000. The net impact of the settlement was approximately \$1.8 million, which included an escrow adjustment in the first quarter 2008 of \$1.4 million and approximately \$398,000 in interest and net legal fees. This award was paid to the Company in April 2008, and the time for the Seller to move to vacate or modify this award has now expired.

d. Purchase of the Minority Interest in MDT and MDT Armor

In January 2008, the Company purchased the minority shareholder’s 24.5% interest in MDT Protective Industries Ltd. (“MDT”) and the 12.0% interest in MDT Armor Corporation (“MDT Armor”), as well as settling all outstanding disputes regarding severance payments, in exchange for a total of \$1.0 million that was paid in cash. The purchase was treated as a step acquisition using the purchase method of accounting. The Company evaluated the purchase price and identified \$607,100 in goodwill and workforce intangibles with an indefinite life. The Company also identified \$53,400 as an intangible asset related to its customer list with a useful life of four years. The purchase price included a payment of \$241,237 to the former president of MDT as compensation for a right granted to him by MDT Armor that potentially would have given him the right to receive 5% of MDT Armor’s annual profit. The payment for this right was recorded as general and administrative expense in the first quarter of 2008.

e. Acquisition of Realtime Technologies, Inc.

In February 2008 the Company’s FAAC subsidiary acquired all of the outstanding stock of Realtime Technologies, Inc. (RTI), a privately-owned corporation headquartered in Royal Oak, Michigan, for a total of \$1,387,000, including \$1,250,000 in cash, \$100,000 in Company stock (54,348 shares) and approximately

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

\$37,000 in legal fees along with a contingent earnout of \$250,000 that was earned in 2008 and recorded as compensation expense. RTI specializes in multi-body vehicle dynamics modeling and graphical simulation solutions. RTI's product portfolio provides FAAC with the opportunity to economically add new features to the driver training products marketed by FAAC.

RTI's operating results are included in the Company's Training and Simulation Division as of January 1, 2008 and the effect on operations was not material.

Listed below is the purchase price allocation:

Current assets acquired, net of liabilities....	\$	433,389
Technology and Patents - 7 year life		663,000
Trademark/Trade Names - 10 year life		28,000
Customer relationships - 10 year life		62,000
Goodwill - indefinite life.....		200,222
Equity Value.....	\$	<u>1,386,611</u>

f. Impairment of goodwill and other intangible assets:

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement, at least annually thereafter, and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. The Company's reporting units are the training and simulation segment, the Armor segment and Epsilor, a component within the Battery and Power segment. 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 and weighted average cost of capital.

In both 2008 and 2007, the Company evaluated all goodwill at mid-year and determined that there was no impairment.

The Company completed its annual goodwill impairment review at the end of the quarter ended June 30, 2008. Although the cumulative book value of the Company's reporting units exceeded the Company's market value as of the impairment review, management nevertheless determined that the fair value of the respective reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill. Several factors contributed to this determination:

- The long term horizon of the valuation process versus a short term valuation using current market conditions;
- The valuation by individual business segments versus the market share value based on the Company as a whole; and
- The fact that the Company's stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in the Company's securities was not acting as an informationally efficient reflection of all known information regarding the Company.

In view of the above factors, management felt that in the current market as of June 30, 2008, the Company's stock was undervalued, especially when compared to the estimated future cash flows of the underlying entities.

Due to the extreme volatility in the stock market, changing current market conditions and the effect on the Company's common stock price during the year ended December 31, 2008, the Company decided to update the goodwill impairment studies originally conducted as of June 30, 2008. Consistent with the June 30, 2008 analysis, the Company used the discounted future cash flow method to determine the value of the Company and its subsidiaries. The Company believes that its stock price has historically traded at a much higher value and that the current stock price and resultant market capitalization amount are a short term

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

condition. The Company concluded that the collective value of its individual business units on a longer term horizon exceeds the value of the short term market assessments of the Company's common stock.

The results of the updated assessments confirmed the previously conducted studies as of June 30, 2008 that there is no impairment of goodwill as of December 31, 2008.

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.

g. 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 was extended automatically for additional term of two years until December 31, 2010, unless either Sampen or the Company terminates 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, 2008 and 2007 the Company paid Sampen a total of \$178,424 and \$219,354, 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 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, 2008, 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, 2008, the aggregate amount outstanding pursuant to this promissory note was \$818,357.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
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In U.S. dollars

NOTE 1:– GENERAL (Cont.)

stock acquired through the exercise of the options. As of December 31, 2008, the aggregate amount outstanding pursuant to this promissory note was \$46,593.

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.

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, 2008 the Company and its subsidiaries classified its investment in marketable securities as available-for-sale.

AROTECH CORPORATION AND ITS SUBSIDIARIES
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NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 2008 and 2007, the Company wrote off \$154,463 and \$150,681, 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 and direct 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 2008 and 2007).

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

	<u>Depreciable Life (in years)</u>
Computers and related equipment	3 to 5
Motor vehicles	5 to 7
Demo inventory	5
Office furniture and equipment	10
Machinery and equipment	10
Buildings	30
Leasehold improvements	By the shorter of the term of the lease or the life of the asset

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 2008 and 2007, 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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues from contracts in the Training and Simulation division that involve customization of the 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, materials and other costs 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.

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 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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

warranty and records deferred revenue 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 reserves and adjusts the amounts as necessary.

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, 2008.

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 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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 1,697,266 and 1,791,562, for the years ended December 31, 2008 and 2007, 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 Company did not grant any options in 2007 or 2008. The Company assumed a 20% forfeiture rate for options for both years. The Company uses a 10% forfeiture rate for restricted stock and adjusts both forfeiture rates based on historical forfeitures.

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 and other receivables, short-term bank credit, and trade payables approximate their fair value due to the short-term maturity of such instruments.

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

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

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, 2008 and 2007, the accumulated severance pay in that regard amounted to \$2,160,428 and \$2,081,586, respectively.

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NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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, 2008, a total of \$587,905 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, 2008 and 2007 amounted to \$202,627 and \$334,749, respectively.

s. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2008 and 2007 was approximately \$100,347 and \$92,775, 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 Company'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 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 Company beginning January 1, 2008. In February 2008, the FASB issued 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. On January 1, 2008, the Company adopted the provisions of SFAS No. 157 for its financial assets and liabilities. The adoption of the standard did not have a material impact on the Company's financial statements. The Company elected to defer the adoption of SFAS No. 157 for its non-financial assets and liabilities until January 1, 2009. The Company is currently evaluating the impact that the deferred provisions of this standard will have on its financial statements.

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 was effective for the Company

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

beginning January 1, 2008. The adoption of the standard did not have a material impact on the Company's financial statements.

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 Company's results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. SFAS No. 161 requires expanded disclosures regarding the location and amounts of derivative instruments in an entity's financial statements, how derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and how derivative instruments and related hedged items affect an entity's financial position, operating results and cash flows. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. Since SFAS No. 161 affects only disclosures, it is not expected to impact the Company's financial position or results of operations upon adoption.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS No. 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with generally accepted accounting principles in the United States for non-governmental entities. SFAS No. 162 is effective 60 days following approval by the SEC of the Public Company Accounting Oversight Board's amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." The Company does not expect that the adoption of SFAS No. 162 will materially impact its financial position or results of operations.

In May 2008, the FASB issued FASB Staff Position No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* ("FSP No. APB 14-1"). FSP No. APB 14-1 clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Additionally, FSP No. APB 14-1 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP No. APB 14-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. The Company does not expect the adoption of this pronouncement will materially impact its financial position or results of operations.

In June 2008, the FASB ratified the consensus reached on Emerging Issues Task Force Issue No. 07-05, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock* ("EITF Issue No. 07-5"). EITF Issue No. 07-05 clarifies the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock, which would qualify as a scope exception under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. EITF Issue No. 07-05 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption for an existing instrument is not permitted. The adoption of this pronouncement will require the warrants

AROTECH CORPORATION AND ITS SUBSIDIARIES
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In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

and conversion option of the convertible debt to be accounted for as liabilities and marked to fair value at each reporting period.

In June 2008, the FASB issued FASB Staff Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP No. EITF 03-6-1), which classifies unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) as participating securities and requires them to be included in the computation of earnings per share pursuant to the two-class method described in SFAS No. 128, Earnings per Share. This Staff Position is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period earnings per share data presented are to be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of this Staff Position, with early application not permitted. The Company is currently evaluating the effect that the adoption of FSP No. EITF 03-6-1 will have on its financial position, results of operations and cash flows.

In September 2008 the FASB issued FSP FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161. This FSP amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, to require disclosures by sellers of credit derivatives, including credit derivatives embedded in a hybrid instrument. This FSP also amends FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, to require an additional disclosure about the current status of the payment/performance risk of a guarantee. Further, this FSP clarifies the Board's intent about the effective date of FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities. The Company does not expect the adoption of this pronouncement to materially impact its financial position or results of operations.

u. Reclassification:

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

NOTE 3:– RESTRICTED COLLATERAL DEPOSITS

	December 31,	
	2008	2007
Short-term:		
Deposits in connection with MDT projects	\$ 381,586	\$ 254,668
Deposits in connection with EFL projects	–	65,786
Total Restricted Collateral.....	<u>\$ 381,586</u>	<u>\$ 320,454</u>

NOTE 4: – AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2008 and 2007:

	Cost		Unrealized gains		Estimated fair value	
	2008	2007	2008	2007	2008	2007
Available for sale market- able securities.....	\$ 47,005	\$ 41,166	\$ 2,199	\$ 5,839	\$ 49,204	\$ 47,005

NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2008	2007
Government authorities	\$ 114,090	\$ 259,036
Employees	45,458	60,950
Prepaid expenses.....	623,561	790,158
Loan to non-affiliated entity	2,531,250	–
Other	311,596	504,470
Total	<u>\$ 3,625,955</u>	<u>\$ 1,614,614</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES H(Cont.)

In August 2008, the Company purchased a \$2,500,000 10% Senior Subordinated Convertible Note from an unaffiliated company. This 10% Senior Subordinated Convertible Note is due December 31, 2009. The issuer is required to pay interest on a quarterly basis starting in November, 2008 and pay the entire principal by December 31, 2009. The note is convertible at maturity at our option into such number of shares of DEI's common stock, no par value per share, as shall be equal at the time of conversion to twelve percent (12%) of DEI's outstanding common stock.

Management has determined that the Senior Subordinated Convertible Note, in the event of an impairment, would be valued using Level 2 inputs under SFAS 157, using inputs related to interest rates, term of the note and relative risk on similar notes available in the marketplace.

NOTE 6:– INVENTORIES

	December 31,	
	2008	2007
Raw and packaging materials	\$ 6,798,662	\$ 6,043,170
Work in progress	2,251,734	1,583,790
Finished products	628,564	260,860
Total.....	<u>\$ 9,678,960</u>	<u>\$ 7,887,820</u>

NOTE 7:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2008	2007
Cost:		
Computers and related equipment	\$ 2,408,734	\$ 2,494,370
Motor vehicles.....	529,685	561,737
Office furniture and equipment.....	1,030,199	1,194,132
Machinery, equipment and installations.....	5,499,776	4,485,959
Buildings.....	1,172,072	1,172,072
Land	115,538	115,538
Leasehold improvements.....	973,360	846,271
Demo inventory	1,424,831	1,150,129
	<u>\$ 13,154,195</u>	<u>\$ 12,020,208</u>
Accumulated depreciation:		
Computers and related equipment	2,163,444	2,061,044
Motor vehicles.....	290,839	249,627
Office furniture and equipment.....	648,278	536,472
Machinery, equipment and installations	3,671,997	3,132,202
Buildings	55,097	25,045
Leasehold improvements.....	611,139	407,030
Demo inventory	655,138	528,992
	<u>8,095,932</u>	<u>6,940,412</u>
Property and equipment, net	<u>\$ 5,058,263</u>	<u>\$ 5,079,796</u>

b. Depreciation expense amounted to \$1,246,238 and \$1,376,749 for the years ended December 31, 2008 and 2007, 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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
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NOTE 8:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

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

	12/31/07	Additions	Adjustments (currency)	12/31/08
Simulation.....	\$24,235,419	\$ 200,222	\$ –	\$ 24,435,641
Battery.....	5,946,649	–	68,820	6,015,469
Aarmor	1,176,063	607,100	16,230	1,799,393
Total	<u>\$31,358,131</u>	<u>\$ 807,322</u>	<u>\$ 85,050</u>	<u>\$ 32,250,503</u>

b. Other intangible assets:

		December 31,			
		2008		2007	
	Useful life	Cost	Net Book Value	Cost	Net Book Value
Technology.....	4-8 years	\$ 7,068,000	\$ 2,297,036	\$ 6,405,000	\$ 2,305,000
Capitalized software costs.....	1-3 years	1,720,991	100,408	1,720,991	442,816
Trademarks.....	10 years	28,000	25,200	–	–
Backlog	1-10 years	744,000	55,800	682,000	–
Covenants not to compete	5 years	99,000	–	99,000	–
Customer list	2-10 years	7,602,045	3,186,342	7,548,645	3,846,117
Certification	3 years	246,969	–	246,969	–
		<u>17,509,005</u>	<u>\$ 5,664,786</u>	<u>16,702,605</u>	<u>\$ 6,593,933</u>
Exchange differences.....		404,088		444,143	
Less - accumulated amortization		<u>(11,844,220)</u>		<u>(10,108,672)</u>	
Amortized cost.....		6,068,873		7,038,076	
Trademarks		799,000		799,000	
Net book value.....		<u>\$ 6,867,873</u>		<u>\$ 7,837,076</u>	

Amortization expense amounted to \$1,735,548 and \$1,381,822 for the years ended December 31, 2008 and 2007, respectively, including amortization of capitalized software costs of \$342,408 and \$552,689, respectively.

c. Estimated amortization expenses for the years ended:

Year ended December 31,	
2009.....	\$ 1,452,741
2010.....	1,315,418
2011.....	1,315,054
2012.....	725,454
2013.....	725,403
2014 and forward.....	130,716
Total.....	<u>\$ 5,664,786</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 \$8.4 million authorized in credit lines from certain banks, of which \$877,000 is denominated in NIS and carries various approximate interest rates of prime rate + 2.6 to 4.3% and \$7.5 million is denominated in U.S. dollars (the Company's primary line which expires in December, 2009) and carries an interest rate of lender's prime rate + 0.25%. The interest rate charged by the bank for this latter line was 3.5% at December 31, 2008. As of December 31, 2008, \$4.4 million was utilized from the Company's primary line, out of which \$744,000 is related to four letters of credit issued to customers of two of the Company's subsidiaries. The entire amount of the remaining \$3.1 million of credit on the primary line was available at year end.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS (Cont.)

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,	
	2008	2007
Employees and payroll accruals.....	\$ 1,557,628	\$ 1,531,157
Accrued vacation pay	675,142	530,850
Accrued expenses	1,759,873	1,813,947
Government authorities.....	333,390	401,826
Advances from customers.....	1,532,926	611,949
Total	<u>\$ 5,858,959</u>	<u>\$ 4,889,729</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.

Royalties paid or accrued for the years ended December 31, 2008 and 2007 to the OCS amounted to \$11,821 and \$15,063, respectively.

As of December 31, 2008, the total contingent liability to the OCS was approximately \$10.6 million. 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, 2008.

As of December 31, 2008, 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 through 2018. The minimum rental payments under non-cancelable operating leases are as follows:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

<u>Future Minimum Rental Payments</u>	<u>December 31</u>
2009.....	\$ 724,821
2010.....	510,119
2011.....	517,994
2012.....	523,332
2013.....	336,282
Thereafter.....	1,304,416
Total.....	<u>\$ 3,916,964</u>

Total rent expenses for the years ended December 31, 2008 and 2007 were \$805,518 and \$890,406, respectively.

The existing capital 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 assets included. The net book value is included the property and equipment totals in the balance sheet.

<u>Leased Assets</u>	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Equipment	\$ 355,561	\$ 249,532
Less: Accumulated Depreciation.....	(179,429)	(97,789)
Net book value.....	<u>\$ 176,132</u>	<u>\$ 151,743</u>

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

<u>Liabilities</u>	<u>December 31, 2008</u>
Obligations under capital leases:	
Current	\$ 85,394
Non-current.....	148,772
Total minimum payments	234,166
Less: Interest.....	(49,243)
Present value of payments.....	<u>\$ 184,923</u>

The table below details the future lease payments due as of December 31, 2008.

<u>Future Minimum Lease Payments</u>	<u>December 31,</u>
2009	\$ 85,394
2010	64,959
2011	46,949
2012	30,294
2013 and forward	6,570
Total minimum lease payments.....	<u>\$ 234,166</u>

c. **Guarantees:**

The Company obtained bank guarantees in the amount of \$144,000 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 four outstanding letters of credit totaling \$744,000 for the benefit 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 Epsilor 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.

The Company has \$8.4 million in credit liens secured by the assets of the Company and its subsidiaries and guaranteed by the Company and its subsidiaries.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

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

e. Litigation and other claims:

As of the date of this filing, there were no material pending legal proceedings against the Company, except as follows:

1. NAVAIR Litigation

In December 2004, AoA filed an action in the United States Court of Federal Claims against the United States Naval Air Systems Command (NAVAIR), seeking approximately \$2.2 million in damages for NAVAIR's alleged improper termination of a contract for the design, test and manufacture of a lightweight armor replacement system for the United States Marine Corps CH-46E rotor helicopter. NAVAIR, in its answer, counterclaimed for approximately \$2.1 million in alleged reprocurement and administrative costs. Trial has been held in this matter, and the Company is awaiting a decision.

2. Class Action Litigation

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 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 Armour of America 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 its financial statements and reports were not prepared in accordance with GAAP and SEC rules. The Complaint seeks an unspecified amount of damages. The Company's motion to dismiss the Complaint as a matter of law was denied in March 2009.

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

a. Subordinated convertible notes due August 14, 2011

In August 2008, the Company issued \$5.0 million in 10% subordinated convertible notes due August 15, 2011. The notes are convertible at the option of the holders at a fixed conversion price of \$2.24. The principal amount of the notes is payable over a period of three years, with the principal amount being amortized in eleven payments payable at the Company's option in cash and/or stock, by requiring the holders to convert a portion of their notes into shares of the Company's common stock, provided certain conditions are met. The failure to meet such conditions could make the Company unable to pay its notes, causing it to default. If the price of the Company's common stock is above \$2.24, the holders of its notes will presumably convert their notes to stock when payments are due, or before, resulting in the issuance of additional shares of the Company's common stock.

Principal payments of \$454,545 are due on each of February 13, 2009, May 15, 2009, August 14, 2009, November 13, 2009, February 15, 2010, May 14, 2010, August 13, 2010, November 15, 2010, February 15, 2011, May 13, 2011 and August 15, 2011, either in cash or by requiring the holder to convert the principal payment into shares of the Company's common stock. The Company paid the principal payment due February 13, 2009 in cash. In the event the Company elects to make payments of principal on its convertible notes in stock by requiring the holders to convert a portion of their Notes, either because its

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

cash position at the time makes it necessary or it otherwise deems it advisable, the price used to determine the number of shares to be issued on conversion will be calculated using an 8% discount to the average trading price of the Company's common stock during 17 of the 20 consecutive trading days ending two days before the payment date. Accordingly, the lower the market price of the Company's common stock at the time at which it makes payments of principal in stock, the greater the number of shares the Company will be obliged to issue and the greater the dilution to its existing stockholders.

The Company can require the holder of its Notes to convert a portion of their Notes into shares of the Company's common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. As a result, the Company would need to file an additional registration statement with the SEC to register for resale more shares of its common stock in order to continue requiring conversion of the Company's Notes upon principal payment becoming due.

The Notes include certain customary restrictive covenants and rights upon an event of default. The events of default includes suspension of trading, failure to cure a conversion failure, failure to timely make principal and interest payments, defaults on other credit arrangements, bankruptcy, judgments in excess of \$1,000,000 and generally any uncured breach of the Notes.

Contemporaneously with the signing of a securities purchase agreement for the above notes, the Company also executed a Registration Rights Agreement. This agreement required the registration of additional shares of the Company and that the registration statement, which was declared effective in 2008, remains effective throughout the term of the Notes. If it were to cease to be effective for any reason, the Company would owe the Note holders 1.5% of the remaining principal amount of the Notes for each month that the registration statement was not effective. The maximum amount due per month as of December 31, 2008 would be \$75,000 and would decrease as the principal is repaid. Additional requirements of this agreement require the Company to, among other things, abide by all rules and regulations of the SEC and timely file all required reports. As of December 31, 2008, the Company was in compliance with all requirements of this agreement.

The debt discount associated with this transaction will be charged to financial expense over the term of the Notes using the effective interest method. (See discussion on warrants in Note 13.b.) The net amount due on the notes as of December 31, 2008, net of this discount, was \$4,639,237.

b. 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.

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, the Company recorded expenses of \$18,745 attributable to amortization related to warrants issued to the holders of the Notes and the beneficial conversion feature. During 2007 the Company also recorded expenses of \$280,382 attributable to debt discount at time of payment, in connection with convertible debenture principle repayment of the Notes. Additionally, during 2007 the Company recorded expenses of \$44,253 attributable to amortization of deferred charges related to issuance of the Notes.

During 2007, the Company issued a total of 930,125 shares in payment of these notes.

c. 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

AROTECH CORPORATION AND ITS SUBSIDIARIES
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In U.S. dollars

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

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.

<u>Mortgage Future Payments</u>	<u>December 31,</u>
2009.....	\$ 27,105
2010.....	29,355
2011.....	31,792
2012.....	34,423
2013.....	37,287
Thereafter.....	912,813
	<u>\$ 1,072,775</u>

The Company has additional long term debt outstanding of \$15,902, primarily vehicle loans. This amount is payable 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. As part of a securities purchase agreement entered into in August 2008, the Company issued to the purchasers of its 10% senior convertible notes due August 15, 2011, warrants to purchase an aggregate of 558,036 shares of common stock at any time prior to August 15, 2011 at a price of \$2.24 per share. The warrants were classified as equity based on their relative value of \$412,300.

The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.78%, a volatility factor 75%, dividend yields of 0% and a contractual life of 3.0 years.

2. As of December 31, 2008, the Company's outstanding warrants totaled 714,658 with expiration dates through August 15, 2011 and with exercise prices ranging from \$2.24 to \$30.80.

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.

1. 1998 Employee Option Plan – as amended, 339,286 shares reserved for issuance, no new options are issuable under this Plan as of December 31, 2008. Pursuant to the terms of this Plan, no new options were issuable under this Plan after December 31, 2008.

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, 2008. 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 zero were available for future grants to employees and consultants as of December 31, 2008.

4. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 670,410 were available for future grants to outside directors as of December 31, 2008.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
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NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

vest after three years or pursuant to defined performance criteria; in the event that employment is terminated within that period, unvested restricted shares generally 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, 2008 and 2007, and changes during the years ended on those dates, is presented below:

Stock Options:

	2008		2007	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		\$		\$
Options outstanding at beginning of year	291,390	\$ 6.03	623,693	\$ 8.22
Changes during year:				
Granted	—	\$ —	—	\$ —
Exercised	—	\$ —	—	\$ —
Forfeited	(54,484)	\$ 5.52	(332,303)	\$ 10.14
Options outstanding at end of year	236,906	\$ 6.14	291,390	\$ 6.03
Options vested at end of year ⁽¹⁾	203,908	\$ 6.69	217,057	\$ 7.14
Options expected to vest	32,998	\$ 2.77	74,333	\$ 2.77

- (1) Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2008 and 2007 was \$1,039,270 and \$1,417,521, respectively.

The calculated intrinsic value of vested and unvested options for 2008 and 2007 was less than zero.

Restricted Shares:

	2008		2007	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
		\$		\$
Nonvested at the beginning of the year	994,452	\$ 2.42	863,572	\$ 2.51
Changes during year:				
Granted	38,472	\$ 2.73	631,118	\$ 2.36
Vested	(244,538)	\$ 2.39	(500,238)	\$ 2.62
Forfeited	(75,073)	\$ 2.22	—	\$ —
Nonvested at the end of the year	713,313	\$ 2.41	994,452	\$ 2.42
Restricted shares vested at end of year	793,347	\$ 2.53	548,809	\$ 2.51

Under the plans discussed above, 38,472 restricted shares and 41,118 restricted shares were granted to the Company's directors in 2008 and 2007, respectively. Additionally, 590,000 restricted shares were granted to the officers of the company during 2007. The officers were not granted any shares in 2008.

7. The options outstanding as of December 31, 2008 have been separated into ranges of exercise price, as follows:

AROTECH CORPORATION AND ITS SUBSIDIARIES
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NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

Range of exercise prices	Total options outstanding			Vested options outstanding	
	Amount outstanding at December 31, 2008	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2008	Weighted average exercise price
		Years	\$		\$
0.00-4.99.....	99,000	2.97	\$ 2.77	66,002	\$ 2.77
5.00-9.99.....	102,752	3.09	\$ 5.86	102,752	\$ 5.86
10.00-34.99...	35,154	3.42	\$ 16.49	35,154	\$ 16.49
Total.....	236,906	3.09	\$ 6.14	203,908	\$ 6.69

8. Options issued to consultants:

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

	2008		2007	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		\$		\$
Options outstanding at beginning of year.....	11,870	\$ 54.39	11,870	\$ 54.39
Changes during year:				
Granted.....	—	—	—	—
Exercised.....	—	—	—	—
Forfeited or cancelled.....	(4,553)	\$ 32.12	—	—
Options outstanding at end of year.....	7,317	\$ 68.24	11,870	\$ 54.39
Options vested at end of year.....	7,317	\$ 68.24	11,870	\$ 54.39

In connection with the grant of stock options to consultants, the Company did not recognize any expenses for the years ended December 31, 2008 and 2007.

9. 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, 2008 was \$407,755, of which \$25,571 was for stock options and \$382,184 was for restricted shares. The weighted average period over which this compensation cost is expected to be recognized is approximately 1.5 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.

NOTE 14:– INCOME TAXES

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

As of December 31, 2008, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$24.9 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 not impact the Company's financial condition, results of operations or cash flows. At December 31, 2008, the Company had net deferred tax assets of \$37.9 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 may have occurred. The Company completed a Section 382 analysis in

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

2007 regarding the limitation of the net operating losses and 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 Deferred Tax Asset 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 reevaluated the unrecognized tax benefits under FIN 48 as of December 31, 2008 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 the Company's unrecognized tax benefits will not impact the Company's effective tax rate.

The Company has indefinitely-lived intangible assets consisting of trademarks, workforce, and goodwill. Pursuant to SFAS No. 142, "Goodwill and Other Intangible Assets," these indefinitely-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these indefinitely-lived intangible assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a "naked tax credit." This deferred tax liability could remain on the Company's balance sheet indefinitely unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

Due to the fact that the aforementioned deferred tax liability could have an indefinite life, it should not be netted against the Company's deferred tax assets (which primarily relate to net operating loss carryforwards) when determining the required valuation allowance. Doing so would result in the understatement of the valuation allowance and related deferred income tax expense.

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 2004, although carryforward losses that were generated prior to 2004 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 2003.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

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.

2. Program two:

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

The 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 program 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 26% in 2009 and 25% in 2010 and thereafter.

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, 2008 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, 2008. 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.

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 (program one) 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, 2008, the Company did not generate income under the provision of the amended Investment Law.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:-- INCOME TAXES (Cont.)

c. Other tax information about the Israeli subsidiaries:

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

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

2. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter. See also Note 14.e.

3. Tax loss carryforwards:

As of December 31, 2008, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$105 million, which are available, indefinitely, to offset future taxable income.

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

The corporate tax rate in Israel was 29% in 2007 and 27% in 2008. Current law has set the rate at 26% for 2009 and 25% for 2010 and thereafter, although this is subject to being changed by the Israeli parliament.

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,	
	2008	2007
		(as restated; see Note 19)
Operating loss carryforward.....	\$ 34,958,606	\$ 33,741,900
Other temporary differences	2,894,915	4,088,598
Net deferred tax asset before valuation allowance..	37,853,521	37,830,498
Valuation allowance	(37,781,407)	(37,752,789)
Total deferred tax asset.....	\$ 72,114	\$ 77,709
Deferred tax liability.....	\$ 2,430,000	\$ 1,865,000
	December 31,	
	2008	2007
		(as restated; see Note 19)
Domestic.....	\$ 8,470,576	\$ 7,216,709
Foreign.....	26,488,030	26,525,191
	<u>\$34,958,606</u>	<u>\$ 33,741,900</u>

The Company has 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 the Company is 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, 2008 was \$28,000.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:-- INCOME TAXES (Cont.)

- f. Loss before taxes on income and minorities interests in earnings of a subsidiary:

	Year ended December 31	
	2008	2007
		(as restated; see Note 19)
Domestic.....	\$ (1,929,564)	\$ (2,464,512)
Foreign.....	(881,524)	(365,711)
	<u>\$ (2,811,088)</u>	<u>\$ (2,830,223)</u>

- g. Taxes on income were comprised of the following:

	Year ended December 31	
	2008	2007
		(as restated; see Note 19)
Current state and local taxes	\$ 499,196	\$ 111,162
Deferred taxes	570,595	545,323
Taxes in respect of prior years ...	(42,923)	(47,569)
	<u>\$ 1,026,868</u>	<u>\$ 608,916</u>
Domestic.....	\$ 926,182	\$ 634,930
Foreign	100,686	(26,014)
	<u>\$ 1,026,868</u>	<u>\$ 608,916</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:

	Year ended December 31,	
	2008	2007
		(as restated; see Note 19)
Loss before taxes and minority interest, as reported in the consolidated statements of operations.....	<u>\$(2,811,088)</u>	<u>\$(2,830,223)</u>
Statutory tax rate	<u>34%</u>	<u>34%</u>
Theoretical income tax on the above amount at the U.S. statutory tax rate	\$ (955,770)	\$ (962,276)
Deferred taxes on losses for which valuation allow- ance was provided	1,872,798	1,400,412
Non-deductible credits (expenses)	(352,029)	126,864
Foreign non-deductible expenses.....	32,400	27,748
State taxes	361,182	69,930
Foreign income in tax rates other than U.S rate	(35,782)	(5,969)
Taxes in respect of prior years	(42,923)	(47,569)
Others	146,992	(224)
Actual tax expense	<u>\$ 1,026,868</u>	<u>\$ 608,916</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 15:- SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expenses), net:

	Year ended December 31,	
	2008	2007
Financial expenses:		
Interest, bank charges and fees	\$ (579,913)	\$ (662,789)
Expenses in connection with convertible debenture principle repayment	—	(280,382)
Bonds discount amortization	(51,537)	(18,745)
Foreign currency translation differences	(291,869)	—
Other	(99)	(91,624)
	<u>(923,418)</u>	<u>(1,053,540)</u>
Financial income:		
Interest	97,851	53,298
Foreign currency translation differences	—	94,354
Other	11,478	—
Total	<u>\$ (814,089)</u>	<u>\$ (905,888)</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.

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:

	Training and Simulation	Armor	Battery and Power Systems	All Others	Total
2008					
Revenues from outside customers	\$ 36,032,703	\$ 17,762,439	\$ 15,153,827	\$ —	\$ 68,948,969
Depreciation, amortization and impairment expenses ⁽¹⁾	(1,573,017)	(175,733)	(1,033,374)	(199,662)	(2,981,786)
Direct expenses ⁽²⁾	(30,141,747)	(18,457,799)	(14,368,970)	(6,022,534)	(68,991,050)
Segment net income (loss)	\$ 4,317,939	\$ (871,093)	\$ (248,517)	\$ (6,222,196)	\$ (3,023,867)
Financial expenses	(195)	(357,517)	(313,671)	(142,706)	(814,089)
Net income (loss)	\$ 4,317,744	\$ (1,228,610)	\$ (562,188)	\$ (6,364,902)	\$ (3,837,956)
Segment assets ^{(3) (4)}	\$ 48,181,444	\$ 12,572,672	\$ 24,037,512	\$ 5,003,171	\$ 89,794,799
2007 (as restated; see Note 19)					
Revenues from outside customers	\$ 27,760,858	\$ 18,724,107	\$ 11,234,596	\$ —	\$ 57,719,561
Depreciation, amortization and impairment expenses ⁽¹⁾	(1,037,064)	(469,093)	(1,024,434)	(227,980)	(2,758,571)
Direct expenses ⁽²⁾	(22,241,359)	(17,490,430)	(11,023,839)	(6,800,909)	(57,556,537)
Segment net income (loss)	\$ 4,482,435	\$ 764,584	\$ (813,677)	\$ (7,028,889)	\$ (2,595,547)
Financial expenses	(14,610)	(93,292)	(176,834)	(621,152)	(905,888)
Net income (loss)	\$ 4,467,825	\$ 671,292	\$ (990,511)	\$ (7,650,041)	\$ (3,501,435)
Segment assets ^{(3) (4)}	\$ 43,810,684	\$ 11,235,386	\$ 21,191,545	\$ 4,243,692	\$ 80,481,307

(1) Includes depreciation of property and equipment and amortization expenses of 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 \$24,435,642, \$6,015,469 and \$1,799,392 as of December 31, 2008, and \$24,235,419, \$5,946,649 and \$1,176,063 as of December 31, 2007.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

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, 2008 and 2007, and long-lived assets as of December 31, 2008 and 2007:

	2008		2007	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars			
U.S.A.	\$ 49,386,798	\$31,794,288	\$45,198,904	\$31,714,391
Germany	951,533	–	230,571	–
England.....	389,518	–	273,239	–
Thailand.....	–	–	–	–
India.....	1,854,052	–	1,153,521	–
Egypt	538,774	–	–	–
Israel.....	13,443,119	12,382,351	8,239,135	12,560,612
Other.....	2,385,175	–	2,624,191	–
	<u>\$ 68,948,969</u>	<u>\$44,176,639</u>	<u>\$57,719,561</u>	<u>\$44,275,003</u>

d. Revenues from major customers:

	Year ended December 31,	
	2008	2007
Batteries and power systems:		
Customer A	9%	6%
Customer B	3%	0%
Armor:		
Customer C	13%	6%
Customer D	6%	19%
Training and Simulation:		
Customer E	37%	27%

e. Revenues from major products:

	Year ended December 31,	
	2008	2007
Water activated batteries	\$ 1,861,958	\$ 1,629,014
Military batteries	13,291,868	9,605,582
Car, aircraft and other armoring	17,762,440	18,724,107
Simulators.....	36,032,703	27,760,858
Total	<u>\$ 68,948,969</u>	<u>\$ 57,719,561</u>

NOTE 17:– ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income consists of currency translation adjustments of \$1,524,000 and \$1,499,000 at December 31, 2008 and 2007, respectively, and unrealized gains on marketable securities of \$2,000 at both December 31, 2008 and 2007.

NOTE 18:– AFFILIATED COMPANIES

The Company has investments in two affiliated companies, Center for Transportation Safety, Inc. (25% ownership) and Concord Safety Solutions, Pvt. Ltd. (33% ownership), both of which are accounted for under the equity method of accounting.

The Company's interest in the net losses of the affiliated companies totaled \$452,166 and \$40,230 in 2008 and 2007, respectively.

NOTE 19:– PRIOR PERIOD ADJUSTMENT

The accumulated deficit at January 1, 2007 was restated and increased by \$400,000 to \$159,866,123 to reflect the correction of a deferred tax liability resulting from a basis difference between book and tax for goodwill that arose from acquisitions in previous years. Additionally, the deferred tax liability and deferred

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 19:– PRIOR PERIOD ADJUSTMENT (Cont.)

income tax provision as of and for the year ended December 31, 2007 were increased by \$445,000 as a result of this correction. The correction of the 2007 tax provision increased previously reported net loss for the year ended December 31, 2007 by \$445,000 or \$0.04 per share. This error correction is the same issue that was disclosed in the 2007 financial statements of the Company, and it was determined in 2008 that the previously reported number was incorrect and was adjusted in these financials.

<u>2007</u>	<u>As previously reported</u>	<u>Adjustment</u>	<u>Corrected amount</u>
Income taxes	\$ (163,916)	\$ (445,000)	\$ (608,916)
Net loss	\$ (3,056,435)	\$ (445,000)	\$ (3,501,435)
Basic and diluted net loss per share.....	\$ (0.27)	\$ (0.04)	\$ (0.31)

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FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2008 and 2007

Description	Balance at beginning of period	Additions charged to costs and expenses*	Balance at end of period
Year ended December 31, 2008			
Allowance for doubtful accounts	\$ 25,000	\$ (6,000)	\$ 19,000
Allowance for slow moving inventory	1,724,000	155,000	1,879,000
Valuation allowance for deferred taxes	37,753,000	28,000	37,781,000
Totals	\$ 39,502,000	\$ 177,000	\$ 39,679,000
Year ended December 31, 2007			
(as restated; see Note 19)			
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	39,457,000	(1,704,000)	37,753,000
Totals	\$ 41,189,000	\$ (1,687,000)	\$ 39,502,000

*The 2008 and 2007 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
Investment Banker

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 Tuesday, June 9, 2009, at 4:00 p.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

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