

Arotech Corporation
Annual Report 2012

Nasdaq: ARTX



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

TRAINING AND SIMULATION DIVISION



BATTERY AND POWER SYSTEMS DIVISION



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October 2013

Dear Fellow Shareholder,

In 2012, we not only finished the year strongly but set the stage for a record year in 2013, putting in place many programs that are already paying off, and that that we believe will continue to pay off as we go forward.

In our Simulation Division, we were successful in winning a major new simulation program, the “Boom Operator Simulation System” (BOSS), which was an important air simulation win that will give us increased credibility when we compete for air simulation programs in the future.

The Simulation Division turned in record results in 2012, and is positioned for continued growth going forward.

Our Battery Division also saw growth in 2012, with the help of a significant contribution from sales of our SWIPES™ system that fueled growth in our US EFB operation. We expect that growth to continue in the coming years, as we continue developing several large format lithium batteries for military applications, including developing a battery for a stealth submarine, a tank starter battery, a battery to launch a rocket and a battery to power a space satellite.

Having completed the disposition of our money-losing Armor Division in 2012, we are now able to focus all our resources on building our two growing divisions.

We anticipate both divisions reporting record results in 2013.

Sincerely,

A handwritten signature in dark ink, appearing to be '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 1, 2013.

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 two business areas: 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 two divisions. Our divisions and subsidiaries (both 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
- Through FAAC, we provide specialized "use of force" training for police, security personnel and the military under the trade name IES Interactive Training ("IES").

➤ We manufacture and sell lithium and Zinc-Air batteries for defense and security products, including our Soldier Wearable Integrated Power Equipment System (SWIPES)[™] power hubs, 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 under our Epsilon nameplate ("Epsilon"), through our subsidiary Epsilon-Electric Fuel, Ltd. ("Epsilon-EFL"), at Epsilon-EFL's facilities located in Dimona, Israel (in Israel's Negev desert area);
- 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, as well as our Soldier Weara-

ble Integrated Power Equipment System (SWIPES)[™] power hub product, 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 under our Electric Fuel nameplate ("EFL"), at Epsilon-EFL's facilities located in Beit Shemesh, Israel (between Jerusalem and Tel-Aviv).

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 subsidiary Epsilon-EFL; and Arotech's wholly-owned United States subsidiaries, EFB and FAAC. Additionally, we operate under the trade names of IES Interactive Training ("IES"), Realtime Technologies ("RTI") and Electric Fuel Limited ("EFL"). Unless otherwise indicated, all reported figures include only these operations and exclude the discontinued Armor segment.

Between 2002 and December 2011, we were also engaged in utilizing advanced engineering concepts to manufacture military and paramilitary armored vehicles, and employing sophisticated lightweight materials to produce aviation armor, through our Armor Division. In December 2011, our Board of Directors approved management's plan to sell our Armor Division in order to focus on the more profitable and growth-oriented aspects of our business. We completed the sale of our Armor Division in June 2012.

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 Epsilon-EFL are located in Israel (in Beit Shemesh and Dimona, both of which are within Israel's pre-1967 borders). Most of the members of our senior management work extensively out of Epsilon-EFL's facilities in Beit Shemesh; our financial operations are conducted primarily from our principal executive offices in Ann Arbor. FAAC's home offices and facilities are located in Ann Arbor, Michigan, Royal Oak, Michigan and Orlando, Florida. The facilities of EFB 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 larger of our two divisions. During 2012 and 2011, revenues from our Training and Simulation Division were approximately \$59.3 million and \$42.9 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 and Realtime Technologies nameplates;
- Our *Military Operations* group provides weapon simulations used to train military pilots in the effective use of air launched weapons and is also marketed under our FAAC nameplate; and

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

Vehicle Simulation

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

Our Vehicle Simulation group focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, subway trains, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles. In 2012, our Vehicle Simulations group accounted for approximately 8.8% of our Training and Simulation Division's revenues.

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

In January 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. We merged RTI into FAAC in January 2010.

Military Operations

In the area of Military Operations, we believe we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare systems for all branches of the Department of Defense and its related industrial contractors. Our simulations are found in systems ranging from instrumented air combat

and maneuver training ranges (such as Top Gun), full task training devices such as the F-18 Weapon Tactics Trainer, and in the on-board computer of many fighter jet aircraft. We supply on-board software to support weapon launch decisions for the F-15, F-16, F-18, F-22 and Joint Strike Fighter (JSF) fighter aircraft. Additionally, FAAC is a prime contractor in respect of the U.S. Army's Virtual Clearance Training Suite (VCTS) program. In 2012, our Military Operations group (including VCTS) accounted for 78.0% of our Training and Simulation Division's revenues. Our VCTS project accounted for 56.0 % of our Training and Simulation Division's revenues.

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 2012, our Use of Force group accounted for 9.8% 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 illus-

trated 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.

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 2012 and 2011, revenues from our Battery and Power

Systems Division were approximately \$20.8 million and \$19.3 million, respectively.

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

We sell lithium batteries and charging systems, including the SWIPES™ power hubs we produce for the Army's Soldier Warrior program, to the military through our subsidiaries Epsilon-EFL and EFB.

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.

Our Soldier Wearable Integrated Power Equipment System, or SWIPES™, power hub utilizes the MOLLE vest and integrates force protection electronics and communications equipment with an advanced battery. The system utilizes a modular power distribution system that is powered by BA-8180/U, BA-8140/U Zinc-air batteries or the LI-145, BB2590 rechargeable batteries for direct power of equipment, allowing for extended mission times without the burden of power source swaps or charging due to their high energy density, and reducing battery weight soldiers carry by up to 30%. The batteries continuously charge the secondary batteries inside various devices, such as two way radios, GPS units and shot detection systems. The SWIPES™ product allows for individual tailoring by the warfighter and is designed to accept new applications as they become available. The SWIPES™ power hub was recognized by the U.S. Army Research, Development and Engineering Command as one of the U.S. Army's ten greatest inventions of 2010.

COMPETITION

The main competitors for our lithium-ion battery products are Brentronics Inc. in the United States, which controls much of the U.S. rechargeable market, ABSL Power Solutions Limited (a wholly owned subsidiary of CIP Industries Incorporated LLP) 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 manufactur-

ers 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. We are now starting direct marketing efforts to emerging markets where we believe the number of local mature competitors is limited.

MANUFACTURING

Our battery production lines for military batteries and chargers have been ISO-9001 certified since 1994. We believe that Epsilon-EFL's 23,000 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). Our BA-8180/U Zinc-Air battery was recognized by the U.S. Army Research, Development and Engineering Com-

mand as one of the U.S. Army's ten greatest inventions of 2003.

Our Zinc-Air batteries, rechargeable batteries and battery chargers for the military are manufactured through EFB. EFB's facilities have been 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 2012 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 U.S. 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 (Li-SO₂) 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 have 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 Epsilon-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 Epsilon-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 in-

dustry 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, 2012 and 2011, our backlog for the following year was approximately \$87.7 million and \$81.9 million, respectively, divided between our divisions as follows:

Division	2012	2011
Training and Simulation Division	\$ 72,404,000	\$ 71,732,000
Battery and Power Systems Division...	15,293,000	10,196,000
TOTAL:	\$ 87,697,000	\$ 81,928,000

Major Customers

During 2012 and 2011, including both of our divisions, various branches of the United States military accounted for approximately 54% and 46% of our revenues. See "Item 1A. Risk Factors – Risks Related to Government Contracts," below.

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 sales prices of our common stock on the Nasdaq Global Market System:

Year Ended December 31, 2012	High	Low
Fourth Quarter	\$ 1.18	\$ 0.90
Third Quarter.....	\$ 1.00	\$ 0.71
Second Quarter.....	\$ 1.30	\$ 0.85
First Quarter.....	\$ 1.39	\$ 1.11
Year Ended December 31, 2011	High	Low
Fourth Quarter	\$ 1.64	\$ 1.11
Third Quarter.....	\$ 2.24	\$ 1.31
Second Quarter.....	\$ 2.47	\$ 1.18
First Quarter.....	\$ 1.74	\$ 1.29

As of February 28, 2013 we had approximately 169 holders of record of our common stock.

Share Repurchase Program

In February of 2009, we authorized the repurchase in the open market or in privately negotiated transactions of up to \$1.0 million of our common stock. Pursuant to this plan, through December 31, 2012 we have repurchased 638,611 shares of our common stock for \$869,931 (\$857,018 net of commissions), all of which was purchased after April 1, 2009. We did not repurchase any shares during 2012.

The repurchase program is subject to management's discretion.

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 this report below, 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 two business areas: interactive simulation for military, law enforcement and commercial markets; and batteries and charging systems for the military. We operate in two business units:

- 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 (our **Training and Simulation Division**); and
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products, including our Soldier Wearable Integrated Power Equipment System (SWIPES)[™] power hubs, and other military applications (our **Battery and Power Systems Division**).

Between 2002 and December 2011, we were also engaged in utilizing advanced engineering concepts to manufacture military and paramilitary armored vehicles, and employing sophisticated lightweight materials to produce aviation armor, through our Armor Division. In December 2011, our Board of Directors approved management's plan to sell our Armor Division in order to focus on the more profitable and growth-oriented aspects of our business. We completed the sale of our Armor Division in June 2012.

The discontinuation of the Armor Division for accounting purposes resulted in a one-time, pre-tax charge during the fourth quarter of 2011 of approximately \$3.9 million, reflecting an impairment of goodwill and intangibles (\$1.8 million), an impairment of other long-lived assets (\$1.5 million), a write-off of a joint venture investment (\$269,000), and costs associated with change of control provisions and other non-statutory severance expenses (\$302,000). Almost all these charges are non-cash impacting items. In 2012, an additional pre-tax adjustment of approximately \$829,000 was recorded to reflect a loss upon the sale.

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 deferred warranty revenue, impairment of intangible assets and goodwill. We base our estimates and judgments on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Under

different assumptions or conditions, actual results may differ from these estimates.

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

Revenue Recognition

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 FASB ASC 605-35 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 applica-

tion 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 FASB ASC 985-605. 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.

Stock Based Compensation

We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of FASB ASC 505-50. Under FASB ASC 505-50, 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 of options 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.

We have provided a valuation allowance on 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 FASB ASC 740-10, involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We 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 our deferred tax assets in the U.S. and Israel 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 and goodwill. Pursuant to FASB ASC 350-10, 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 for continuing operations unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

Due to the fact that the aforementioned deferred tax liability could have an indefinite life, 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.

We have adopted the provisions of the FASB ASC 740-10. FASB ASC 740-10 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. 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 our future financial statements.

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

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the 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 2012, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

As of December 31, 2012, we had recorded goodwill of \$30.6 million (subsequent to the 2011 goodwill impairment in the amount of \$1.8 million in connection with our decision to reflect the operations of the Armor Division as discontinued, referred to below). We allocate goodwill acquired in a business combination to the appropriate reporting unit as of the acquisition date. Currently our reporting units are also our reportable segments and the associated goodwill was determined when the specific businesses in the reportable segments were purchased. Under FASB ASC 350-10, 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 FASB ASC 350-10, and written down when impaired.

In September 2011, the FASB issued ASU No. 2011-08, "Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment." ASU 2011-08 amends the guidance in Accounting Standards Codification ASC 350-10. Under the revised guidance, when testing goodwill for impairment we have the option of performing a qualitative assessment before calculating the fair value of a reporting unit. If we determine, on the basis of qualitative factors, that it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, the two-step impairment test would not be required. If we cannot determine on the basis of qualitative factors that goodwill is not impaired, goodwill is then tested for impairment by 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 expecta-

tions. 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 using the financial results as of the quarter ended June 30, 2012 along with our forecasted plan developed in the fourth quarter. We use a June 30 date because this allows us to use internal resources that are available before we start our annual audit process (we wait until our June 30 financials were reviewed by our external auditors before we start the actual goodwill impairment analysis). In both 2012 and 2011, we determined, using qualitative factors, that the Training and Simulation goodwill was not impaired. In both 2012 and 2011, we completed the first step of the quantitative analysis of the goodwill in the Battery and Power Systems reporting unit, in which we computed a fair value of that reporting unit. Because the fair value was greater than the carrying value of the unit at the measurement date, the second step of the quantitative impairment assessment was not required and no goodwill was impaired. Although the valuation for Battery and Power Systems Division exceeded the reporting unit's carrying value by 14%, we will continue to monitor the actual results of the reporting unit versus the forecast used for the impairment review and re-evaluate the goodwill as required.

Subsequent to our 2011 annual goodwill impairment review, in December 2011, in connection with our decision to sell our Armor Division and to reflect the operations of the Armor Division as discontinued, we identified an impairment of goodwill and other intangible assets identified with the Armor Division and, as a result, we recorded a goodwill impairment charge in the amount of \$1.8 million during the fourth quarter of 2011.

Although the cumulative carrying value of our reporting units included in continuing operations exceeded our market value as of the impairment review, management nevertheless determined that the fair value of the respective reporting units exceeded their respective carry-

ing 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;
- 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; and
- Control premiums reflected in the reporting unit fair values but not in our stock price.

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

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 one to ten years.

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

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 defer revenue for the estimated cost to repair or replace products along with the appropriate margin for goods 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 deferred revenue is estimated based on actual historical experience. For new products, the warranty deferred revenue 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 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 Epsilor is in New Israeli Shekels ("NIS") and a substantial portion of Epsilor's costs is incurred in NIS. Management believes that the NIS is the functional currency of Epsilor. Accordingly, the financial statements of 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, 2012 and 2011. 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 2012 and 2011 arose as a result of non-cash and impairment charges. These charges were primarily related to our prior acquisitions, financings and stock-based awards to employees. To the extent that we continue certain of these activities during 2013, 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 2012. 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 an 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.

We incurred non-cash charges for amortization of intangible assets in 2012 and 2011 in the amount of \$1.2 million and \$1.9 million, respectively. In addition, we incurred non-cash charges in discontinued operations for impairment of goodwill and other intangible assets in the amount of \$1.8 million during 2011 in respect of our Armor Division. See "Critical Accounting Policies – Goodwill," above.

FINANCINGS AND ISSUANCES OF RESTRICTED SHARES, RESTRICTED STOCK UNITS, OPTIONS AND WARRANTS

The non-cash charges that relate to our financings occurred in connection with our issuance of convertible debt securities with detachable warrants. When we issued convertible securities, we recorded a discount (representing the value of the detachable warrants and the derivative features of the debt) that was amortized ratably over the life of the debenture. When a debenture is converted, however, the entire remaining unamortized discount was immediately recognized as expense in the quarter in which the debenture was converted. During 2012 and 2011, we recorded credits of approximately zero and \$161,000, respectively, attributable to debt discount amortization.

During 2012 and 2011, we issued restricted shares and restricted stock units to certain of our employees and to our directors. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock. 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 or restricted stock units (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.

We incurred non-cash charges related to stock-based compensation in 2012 and 2011 in the amount of \$448,000 and \$408,000, respectively.

During the third quarter of 2008 and 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 were convertible at any time prior to August 15, 2011 at a conversion price of \$2.24 per share.

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 August 15, 2011 at a price of \$2.24 per share. Due to certain exercise price reset provisions, the warrants were accounted for as liabilities at fair

value with changes in fair value reflected as financial income or expense amounting to \$161,000 of income in 2011 through the date such warrants expired unexercised.

Overview of Operating Performance and Backlog

Overall, our pre-tax loss from continuing operations for 2012 was \$1.4 million on revenues of \$80.1 million, compared to a pre-tax loss of \$3.4 million on revenues of \$62.1 million during 2011. As of December 31, 2012, our overall backlog for continuing operations totaled \$87.7 million.

In our Training and Simulation Division, revenues increased from approximately \$42.9 million in 2011 to \$59.3 million in 2012. As of December 31, 2012, our backlog for our Training and Simulation Division totaled \$72.4 million.

In our Battery and Power Systems Division, revenues increased from approximately \$19.3 million in 2011 to approximately \$20.8 million in 2012. As of December 31, 2012, our backlog for our Battery and Power Systems Division totaled \$15.3 million.

Common Stock Repurchase Program

In February 2009, we authorized the repurchase in the open market or in privately negotiated transactions of up to \$1.0 million of our common stock. Pursuant to this plan, through December 31, 2011 we have repurchased 638,611 shares of our common stock for \$869,931 (\$857,018 net of commissions), all of which was purchased after April 1, 2009. At December 31, 2011, we had remaining authorization for the repurchase of up to \$142,982 in shares of our common stock. The repurchase program is subject to the discretion of our management.

Results of Operations

Preliminary Note

Results exclude the operations of the Armor Division, which we reflect as discontinued.

SUMMARY

Following is a table summarizing our results of operations for the years ended December 31, 2011 and 2010, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2012	2011
Revenues:		
Training and Simulation Division.....	\$ 59,270,768	\$ 42,881,573
Battery and Power Systems Division	20,779,666	19,254,005
	<u>\$ 80,050,434</u>	<u>\$ 62,135,578</u>
Cost of revenues:		
Training and Simulation Division.....	\$ 44,822,270	\$ 29,715,897
Battery and Power Systems Division	17,318,768	16,235,033
	<u>\$ 62,141,038</u>	<u>\$ 45,950,930</u>
Research and development expenses:		
Training and Simulation Division.....	\$ 698,349	\$ 819,879
Battery and Power Systems Division	1,345,369	581,989
	<u>\$ 2,043,718</u>	<u>\$ 1,401,868</u>
Selling and marketing expenses:		
Training and Simulation Division.....	\$ 4,513,244	\$ 4,399,952
Battery and Power Systems Division	974,666	854,939
	<u>\$ 5,487,910</u>	<u>\$ 5,254,891</u>
General and administrative expenses:		
Training and Simulation Division.....	\$ 3,456,873	\$ 3,844,279
Battery and Power Systems Division	946,727	1,211,114
Corporate.....	5,649,165	5,622,462
	<u>\$ 10,052,765</u>	<u>\$ 10,677,855</u>

	Year Ended December 31,	
	2012	2011
Amortization of intangible assets:		
Training and Simulation Division.....	\$ 676,299	\$ 1,395,857
Battery and Power Systems Division	509,240	509,240
	<u>\$ 1,185,539</u>	<u>\$ 1,905,097</u>
Operating income (loss):		
Training and Simulation Division.....	\$ 5,103,733	\$ 2,705,709
Battery and Power Systems Division	(315,104)	(138,310)
Corporate.....	(5,649,165)	(5,622,462)
	<u>\$ (860,536)</u>	<u>\$ (3,055,063)</u>
Other income:		
Training and Simulation Division.....	\$ (5,926)	\$ 37,567
Battery and Power Systems Division	(2,327)	—
Corporate.....	(31)	6,285
	<u>\$ (8,284)</u>	<u>\$ 43,852</u>
Allowance for settlements:		
Corporate.....	\$ —	\$ 12,333
	<u>\$ —</u>	<u>\$ 12,333</u>
Financial expense (income):		
Training and Simulation Division.....	\$ 43,221	\$ 47,112
Battery and Power Systems Division	7,639	209,764
Corporate.....	497,126	74,130
	<u>\$ 547,986</u>	<u>\$ 331,006</u>
Income tax expense (benefit):		
Training and Simulation Division.....	\$ (7,688)	\$ (69,734)
Battery and Power Systems Division	—	646,824
Corporate.....	635,844	1,031,521
	<u>\$ 628,156</u>	<u>\$ 1,608,611</u>
Net loss – continuing operations:		
Training and Simulation Division.....	\$ 5,074,126	\$ 2,765,898
Battery and Power Systems Division	(320,416)	(994,898)
Corporate.....	(6,782,104)	(6,734,161)
	<u>\$ (2,028,394)</u>	<u>\$ (4,963,161)</u>

Fiscal Year 2012 compared to Fiscal Year 2011

Revenues. During 2012, we (through our subsidiaries) recognized revenues as follows:

- **Training and Simulation Division** – 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.
- **Battery and Power Systems Division** – EFB and Epsilon-EFL recognized revenues from the sale of batteries, chargers, adapters and power hub products to the military and commercial customers, and under certain development contracts with the U.S. Army.
- **Battery and Power Systems Division** – Epsilon-EFL also recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for continuing operations for 2012 totaled \$80.1 million, compared to \$62.1 million in 2011, an increase of \$18.0 million, or 28.8%. This increase was primarily attributable to the following factors:

- Increased revenues from our Training and Simulation Division (\$16.4 million more in 2012 versus 2011), due primarily to revenue in 2012 related to a major new contract (VCTS).
- Increased revenues from our Battery and Power Systems Division (\$1.5 million more in 2012 versus 2011), due to an increase of \$3.2 million in U.S. sales of SWIPES™, partially offset by a \$1.3 million decrease in Israeli sales.

The table below details the percentage of total recognized revenue by type of arrangement for the years ended December 31, 2012 and 2011:

	Year Ended December 31,	
Type of Revenue	2012	2011
Sale of products	96.0%	93.8%
Maintenance and support agreements.....	2.8%	4.3%
Long term research and development contracts.....	1.2%	1.9%
Total.....	<u>100.0%</u>	<u>100.0%</u>

Cost of revenues. Cost of revenues totaled \$62.1 million during 2012, compared to \$46.0 million in 2011, an increase of \$16.1 million, or 35.2%, due primarily to increased revenues in our Training and Simulation Division and the higher costs associated with

the new VCTS contract, as well as increased sales in the U.S. of the SWIPES™ system. Cost of revenues as a percentage of revenue remained essentially flat in our Battery and Power Systems Division but increased in our Training and Simulation Division due primarily to the product mix and the VCTS contract.

Research and development expenses. Research and development expenses for 2012 were \$2.0 million, compared to \$1.4 million during 2011, an increase of \$642,000, or 45.8%, due primarily to increased spending in the Battery and Power Systems Division for continuing research on the SWIPES™ system, offset by a small reduction of expenses in the Training and Simulation Division.

Selling and marketing expenses. Selling and marketing expenses for 2012 were \$5.5 million, compared to \$5.3 million in 2011, an increase of \$233,000, or 4.4%, due primarily to an increase in the sales force and increases in the demonstration of new products to the military in the Battery and Power Systems Division.

General and administrative expenses. General and administrative expenses for 2012 were \$10.1 million, compared to \$10.7 million in 2011, a decrease of \$625,000, or 5.9%. This decrease was primarily attributable to reductions in corporate and division compensation of \$568,000 and a \$128,000 reduction in legal expense compared to 2011.

Amortization of intangible assets. Amortization of intangible assets totaled \$1.2 million in 2012, compared to \$1.9 million in 2011, a decrease of \$720,000, or 37.8%, due primarily to decreased charges for fully amortized capitalized software in our Training and Simulation Division.

Financial expenses, net. Financial expense totaled \$548,000 in 2012, compared to financial expense of 331,000 in 2011, an increase of \$217,000, or 65.6%, due primarily to an increase in corporate interest and bank charges of \$239,000 along with a \$161,000 decrease in credits recorded in 2011 for warrants. The expense increase was offset by a foreign currency adjustment of \$(345,000).

Income taxes. With respect to some of our subsidiaries that generated net income during 2012, we were able to offset federal taxes against our accumulated loss carry forward. We recorded \$628,000 in tax expense in 2012, compared to \$1.6 million in tax expense in 2011, a decrease of \$980,000, or 61.0%, mainly concerning state and local taxes and taxes in Israel along with “naked” credits (“naked” credits occur when deferred tax liabilities that are created by indefinite-lived assets such as goodwill cannot be used as a source of taxable income to support the realization of

deferred tax assets). This amount includes the required adjustment of taxes due to the deduction of goodwill “naked” credits for U.S. federal taxes, which totaled \$599,000 and \$1.0 million respectively, in non-cash expenses in 2012 and 2011.

Net loss. Due to the factors cited above, net loss from continuing operations was reduced to \$2.0 million in 2012 from \$5.0 million in 2011, a difference of \$3.0 million.

Discontinued operations. As cited above, we have discontinued our Armor Division (see Note 1.d. of the Notes to the Consolidated Financial Statements), which generated a net loss of \$988,000 2012. During 2012, we had incurred additional expenses related to the sale of the Armor Division. Almost all of these charges are non-cash impacting items.

Liquidity and Capital Resources

As of December 31, 2012, we had \$1.6 million in cash and \$186,000 in restricted collateral deposits, as compared to December 31, 2011, when we had \$2.3 million in cash and \$1.7 million in restricted collateral deposits. We also had \$380,000 in available, unused bank lines of credit with our main bank as of December 31, 2012, under a \$10.0 million credit facility under our FAAC subsidiary, which is secured by our assets and the assets of our other subsidiaries and guaranteed by us.

Effective April 30, 2012, we and FAAC entered into an agreement with a different primary bank that has provided us with a replacement \$10.0 million credit facility under our FAAC subsidiary, which is secured by Arotech assets and the assets of our other domestic subsidiaries and guaranteed by Arotech and our other domestic subsidiaries, at a rate of LIBOR plus 375 basis points. This credit facility was scheduled to expire May 2013. The new 2012 credit agreement contains certain covenants, including minimum Earnings Before Interest, Taxes, Depreciation and Amortization (“EBITDA”), quarterly Maximum Increase in Net Advance to Affiliates of less than 90% of EBITDA and an annual Fixed Charge Coverage Ratio of not less than 1.1 to 1.0. At the end of 2012 and as of the filing date of this report, we met all required current covenants. In February 2013, to support our growth, our primary bank increased our credit line by 50%, from \$10 million to \$15 million, and the expiration of the credit line was extended to May 31, 2015. The new credit agreement carries an interest rate of 30 day LIBOR plus 375 basis points and an unused line of credit fee of 0.35%. The new credit agreement also contains certain covenants, which are measured on a rolling twelve-month basis, limiting the Maximum Increase in Net Advance to Affiliates to less than 90% of EBITDA

in 2013 and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0.

We used available funds in 2012 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We purchased approximately \$950,000 of property and equipment during 2012. Our net property and equipment amounted to \$4.5 million as of December 31, 2012.

Net cash used in operating activities for 2012 and 2011 was \$4.4 million and \$5.8 million, respectively, a net change in usage of \$1.4 million. This difference was due primarily to the increased working capital funding requirements for our major projects at both the Simulation and Training Division (VCTS) and Battery and Power Systems Division (SWIPES™). The timing of cash inflows and outflows has impacted us due to the substantial purchases of products to fulfill these contracts. Additionally, the increases in working capital were offset by a decrease in the net loss from continuing operations of \$2.9 million. Net cash used in operating activities has been impacted by a significant increase in unbilled receivables.

Net cash provided by (used in) investing activities for 2012 and 2011 was \$371,000 and \$(2.7) million, a net change of \$3.1 million. This difference was due primarily to the release of \$1.6 million in restricted funds due to the completion of a significant contract by the Training and Simulation Division along with a reduction of \$1.7 million in property and equipment purchases. This was offset by a redemption of available for sale securities of \$399,000 recorded in 2011.

Net cash provided by financing activities for 2012 and 2011 was \$3.5 million and \$4.6 million, respectively, a change of \$1.1 million. This difference was due primarily to changes in short term borrowing under our primary line of credit to support the timing differences associated with our major projects at the Training and Simulation Division and the Battery and Power Systems Division.

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2012, 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

As of December 31, 2012, we had approximately \$9.8 million in short-term bank debt and \$1.9 million in long-term debt outstanding for continuing operations, including current maturities, as compared to December 31, 2011, when we had approximately \$6.6 million in short-term bank debt and \$1.0 million in long-term debt outstanding for continuing operations, including current maturities.

Subject to all of the reservations regarding “forward-looking statements” set forth above, we believe that our present cash position, anticipated cash flows from operations and availability under our lines of credit should be sufficient to satisfy our current estimated cash requirements through the remainder of 2013. 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 infusions. Additionally, we would need to raise additional capital or sell assets 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, 2012 and 2011. With respect to some of our U.S. subsidiaries that operated at a net profit during 2012, we were able to offset federal taxes against our net operating loss carryforward. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. We also set up a tax liability for the impact of the deductions taken for goodwill.

As of December 31, 2012, we had a U.S. net operating loss carryforward of approximately \$43.3 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2020 through 2032, and foreign net operating and capital loss carryforwards of approximately \$85.4 million, which are available indefinitely to offset future taxable income under certain circumstances.

mation 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, 2012, 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.

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, 2012. 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, 2011.

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 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 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,
Ann Arbor, Michigan:

We have audited the accompanying consolidated balance sheets of Arotech Corporation and subsidiaries (the "Company") as of December 31, 2012 and 2011 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, 2012 and 2011, 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.

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.

/s/ BDO USA, LLP

Grand Rapids, Michigan
April 1, 2013

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2012	2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 1,580,627	\$ 2,324,163
Restricted collateral deposits	186,306	1,679,609
Trade receivables	9,639,709	11,883,779
Unbilled receivables	13,374,004	5,722,781
Other accounts receivable and prepaid expenses	1,178,780	1,453,152
Inventories	10,033,525	9,503,171
Discontinued operations – short term	389,272	6,032,625
Total current assets	36,382,223	38,599,280
LONG TERM ASSETS:		
Severance pay fund	4,177,488	3,554,877
Other long term receivables	55,156	58,596
Property and equipment, net	4,464,580	4,631,007
Other intangible assets, net	2,238,273	3,153,104
Goodwill	30,562,298	30,421,198
Discontinued operations – long term	–	683,883
Total long term assets	41,497,795	42,502,665
Total assets	\$ 77,880,018	\$ 81,101,945

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,	
	2012	2011
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables.....	\$ 7,156,327	\$ 6,694,127
Other accounts payable and accrued expenses	4,252,910	3,634,133
Current portion of capitalized leases	—	11,053
Current portion of long term debt	888,839	94,595
Short term bank credit	9,787,779	6,618,431
Deferred revenues.....	3,798,086	4,019,425
Discontinued operations – short term	588,592	7,306,967
Total current liabilities	26,472,533	28,378,731
LONG TERM LIABILITIES:		
Accrued severance pay	6,133,042	5,268,827
Long term portion of capitalized leases.....	—	495
Long term portion of debt	992,917	1,018,750
Deferred tax liability.....	4,920,021	4,321,521
Other long term liabilities	27,590	24,345
Discontinued operations – long term.....	912,813	963,814
Total long-term liabilities	12,986,383	11,597,752
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – \$0.01 par value each;		
Authorized: 50,000,000 shares as of December 31, 2012 and		
2011; Issued and outstanding: 16,151,298 shares and		
15,570,491 shares as of December 31, 2012 and 2011, respec-		
tively.....	161,513	155,705
Preferred shares – \$0.01 par value each;.....		
Authorized: 1,000,000 shares as of December 31, 2012 and 2011;		
No shares issued or outstanding as of December 31, 2012 and		
2011	—	—
Additional paid-in capital	223,181,705	222,786,426
Accumulated deficit	(185,248,923)	(182,232,246)
Notes receivable from stockholders	(908,054)	(954,647)
Accumulated other comprehensive income	1,234,861	1,370,224
Total stockholders' equity	38,421,102	41,125,462
Total liabilities and stockholders' equity	\$ 77,880,018	\$ 81,101,945

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

	December 31,	
	2012	2011
Revenues	\$ 80,050,434	\$ 62,135,578
Cost of revenues	62,141,038	45,950,930
Research and development expenses	2,043,718	1,401,868
Selling and marketing expenses	5,487,910	5,254,891
General and administrative expenses	10,052,765	10,677,855
Amortization of intangible assets	1,185,539	1,905,097
Total operating costs and expenses	80,910,970	65,190,641
Operating loss	(860,536)	(3,055,063)
Other income	(8,284)	(43,852)
Allowance for legal settlements, net	—	12,333
Financial expense, net	547,986	331,006
Total other expense	539,702	299,487
Loss from continuing operations before income tax expense	(1,400,238)	(3,354,550)
Income tax expense	628,156	1,608,611
Loss from continuing operations	(2,028,394)	(4,963,161)
Loss from discontinued operations, net of income tax	(988,283)	(6,563,844)
Net loss	\$ (3,016,677)	\$ (11,527,005)
Other comprehensive income, net of income tax - \$0 for both years		
Foreign currency translation adjustment	(135,363)	(769,515)
Comprehensive loss	(3,152,040)	(12,296,520)
Basic and diluted net loss per share – continuing operations	\$ (0.14)	\$ (0.35)
Basic and diluted net loss per share – discontinued operations	\$ (0.07)	\$ (0.47)
Basic and diluted net loss per share	\$ (0.21)	\$ (0.82)
Weighted average number of shares used in computing basic and diluted net loss per share	14,713,583	14,011,566

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 stockholders' equity
	Shares	Amount					
Balance as of January 1, 2011	14,842,283	\$ 148,423	\$ 221,856,095	\$ (170,705,241)	\$ (954,647)	\$ 2,139,739	\$ 52,484,369
Treasury stock purchase and retirement	(75,402)	(754)	(112,544)	—	—	—	(113,298)
Conversion of convertible notes .	324,326	3,243	639,176	—	—	—	642,419
Stock based compensation	—	—	408,492	—	—	—	408,492
Restricted stock issued	414,284	4,143	(4,143)	—	—	—	—
Restricted stock units vested	65,000	650	(650)	—	—	—	—
Foreign currency translation adjustment	—	—	—	—	—	(769,515)	(769,515)
Net loss	—	—	—	(11,527,005)	—	—	(11,527,005)
Balance as of December 31, 2011	15,570,491	\$ 155,705	\$ 222,786,426	\$ (182,232,246)	\$ (954,647)	\$ 1,370,224	\$ 41,125,462

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 stockholders' equity
	Shares	Amount					
Balance as of January 1, 2012	15,570,491	\$ 155,705	\$ 222,786,426	\$ (182,232,246)	\$ (954,647)	\$ 1,370,224	\$ 41,125,462
Stock based compensation	—	—	447,680	—	—	—	447,680
Restricted stock issued	517,582	5,176	(5,176)	—	—	—	—
Restricted stock units vested	63,225	632	(632)	—	—	—	—
Write-down of shareholder loans	—	—	(46,593)	—	46,593	—	—
Foreign currency translation ad- justment	—	—	—	—	—	(135,363)	(135,363)
Net loss	—	—	—	(3,016,677)	—	—	(3,206,636)
Balance as of December 31, 2012	16,151,298	\$ 161,513	\$ 223,181,705	\$ (185,248,923)	\$ (908,054)	\$ 1,234,861	\$ 38,421,102

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

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	(3,016,677)	(11,527,005)
<i>Adjustments required to reconcile net loss to net cash provided by (used in) operating activities:</i>		
Depreciation	1,087,178	1,103,943
Amortization of intangible assets	1,185,539	1,905,097
Amortization of debt discount	—	39,351
Stock-based compensation	447,680	408,492
Adjustment to value of warrants and embedded features on the senior convertible notes	—	(161,339)
Capital (gain) loss from sale of property and equipment	15,668	(150)
Deferred tax provision	598,500	1,658,813
<i>Changes in operating assets and liabilities:</i>		
Severance pay, net	241,604	186,238
Trade receivables	2,244,070	186,547
Other accounts receivable and prepaid expenses	277,812	(416,270)
Inventories	(530,354)	(1,735,022)
Unbilled receivables	(7,651,223)	(2,441,960)
Deferred revenues	(221,339)	(1,749,100)
Trade payables	462,200	3,437,054
Other accounts payable and accrued expenses	622,022	(2,026,504)
Discontinued operations, including impairment of goodwill and other long-lived assets	(165,884)	5,315,233
Net cash provided by (used in) operating activities	(4,403,204)	(5,816,582)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(950,132)	(2,633,562)
Additions to capitalized software development	(334,700)	(406,118)
Proceeds from sale of property and equipment	13,713	12,354
Sales of available for sale securities	—	399,449
Decrease (increase) in restricted collateral deposits	1,493,303	(6,820)
Discontinued operations	148,661	(114,674)
Net cash provided by (used in) investing activities	\$ 370,845	\$ (2,749,371)

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>2012</u>	<u>2011</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from (repayment of) long term debt.....	\$ 756,863	\$ (816,415)
Change in short term bank credit	3,169,348	4,130,226
Purchase of treasury stock	—	(113,298)
Additions to long term debt.....	—	1,125,000
Discontinued operations	(393,314)	293,509
<i>Net cash provided by (used in) financing activities</i>	<u>3,532,897</u>	<u>4,619,022</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(499,462)	(3,946,931)
CASH DIFFERENCES DUE TO EXCHANGE RATE CHANGES	(212,471)	(97,961)
CASH DIFFERENCES DUE TO EXCHANGE RATE CHANGES – DISCONTINUED		
OPERATIONS	—	108,689
NET CHANGE IN CASH AND CASH EQUIVALENTS – DISCONTINUED	(31,603)	459,881
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	2,324,163	5,800,485
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	<u>\$ 1,580,627</u>	<u>\$ 2,324,163</u>
SUPPLEMENTARY INFORMATION ON NON-CASH AND OTHER		
TRANSACTIONS:		
Interest paid during the year.....	\$ 400,905	\$ 160,215
Taxes on income paid during the year	\$ 38,118	\$ 160,847
Note conversion to common stock	\$ —	\$ 642,419

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") and its wholly-owned subsidiaries (the "Company") provide defense and security products for the military, law enforcement and homeland security markets, including advanced zinc-air and lithium batteries and chargers, and multimedia interactive simulators/trainers. The Company operates primarily through its wholly-owned subsidiaries FAAC Incorporated ("FAAC"), based in Ann Arbor, Michigan with locations in Royal Oak, Michigan and Orlando, Florida; Electric Fuel Battery Corporation ("EFB"), based in Auburn, Alabama; and Epsilor-Electric Fuel Ltd. ("Epsilor-EFL"), based in Dimona, Israel with a location in Beit Shemesh, Israel. EFB and Epsilor-EFL form the Company's Battery and Power Systems Division. IES Interactive Training ("IES") and Realtime Technologies ("RTI") were merged with FAAC in 2007 and 2010, respectively, to create Arotech's Training and Simulation Division. Pursuant to a management decision in the fourth quarter of 2011 and sale in 2012, the Company's Armor Division, consisting of M.D.T. Protective Industries, Ltd. ("MDT"), based in Lod, Israel, and MDT Armor Corporation ("MDT Armor"), based in Auburn, Alabama, along with the trade name of Armour of America Incorporated ("AoA"), are reflected as discontinued operations for all periods presented.

b. Impairment of goodwill and other long-lived assets:

Goodwill and indefinite-lived intangible assets are tested for impairment at least annually and between annual tests in certain circumstances, and written down when impaired. Goodwill is tested for impairment by comparing the fair value of the Company's reporting units with their carrying value. All of the Company's continuing reporting units have goodwill. 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 September 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-08, "Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment." ASU 2011-08 amends the guidance in Accounting Standards Codification ("ASC") 350, Intangibles – Goodwill and Other. Under the revised guidance, when testing goodwill for impairment, the Company has the option of performing a qualitative assessment in order to determine whether it needs to calculate the fair value of a reporting unit. If the Company determines, on the basis of qualitative factors, that it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, the two-step impairment test would not be required. The Company early adopted the ASU in 2011.

In September 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-08, "Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment." ASU 2011-08 amends the guidance in Accounting Standards Codification ("ASC") 350, Intangibles – Goodwill and Other. Under the revised guidance, when testing goodwill for impairment, the Company has the option of performing a qualitative assessment in order to determine whether it needs to calculate the fair value of a reporting unit. If the Company determines, on the basis of qualitative factors, that it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, the two-step impairment test would not be required. The Company early adopted the ASU in 2011.

In both 2012 and 2011, the Company determined, using qualitative factors, that the goodwill for the Training and Simulation reporting unit was not impaired. In both 2012 and 2011, the Company completed the first step of the quantitative analysis of the goodwill in the Battery and Power Systems reporting unit, in which it computed a fair value of that reporting unit. Because the fair value was greater than the carrying value of the unit at the measurement date, the second step of the quantitative impairment assessment was not required and no goodwill was impaired. Although the valuation for Battery and Power Systems Division exceeded the reporting unit's carrying value by 14%, the Company will continue to monitor the actual results of the reporting unit versus the forecast used for the impairment review and reevaluate the goodwill as required. Additionally, the Company performed a complete long-lived asset impairment review of the discontinued Armor reporting unit in 2011 that resulted in the full impairment of that unit's goodwill (\$1,792,339) and property and equipment (\$1,487,219), as reported in discontinued operating results.

Although the cumulative carrying value of the Company's reporting units exceeded the Company's market value as determined by its stock price as of the impairment review, management nevertheless deter-

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

mined that the fair value of the Training and Simulation and Battery and Power Systems reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill for these reporting units. 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, including unallocated corporate costs;
- 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 and thereby serves to understate their value; and
- Control premiums reflected in the reporting unit fair values but not in the Company's stock price.

The Company's long-lived assets and amortizable identifiable intangibles are reviewed for impairment 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.

c. Related parties

The Company has had a consulting agreement with Sampen Corporation since 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 an additional term of two years until December 31, 2014, 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 President. 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 attained 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, 2012 and 2011, the Company paid Sampen a total of \$185,856 each year.

On February 9, 2000, Mr. Ehrlich, the Company's Chief Executive Officer, 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 \$329,163, bearing annual interest at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, 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, 2012 and 2011, the aggregate amount outstanding pursuant to this promissory note was \$452,995. Additionally, there is a former employee with the same arrangement.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

common stock acquired through the exercise of the options. As of December 31, 2012, the aggregate amount outstanding pursuant to this promissory note was \$46,593, which was not repaid and was charged to paid in capital in the fourth quarter of 2012. Pursuant to the terms of the note, the shares of stock securing the note were returned to the Company and retired in 2013 when the loan was not repaid.

d. Discontinued operations

In December 2011, the Company's Board of Directors approved management's plan to sell the Armor Division. On March 8, 2012, the Company signed a non-binding letter of intent to sell the division to an Israeli public company. The sale of the assets was completed in June 2012 at a cash purchase price of \$50,000. Unless otherwise indicated, discontinued operations are not included in the Company's reported results.

Unless otherwise noted, amounts and disclosures throughout the Notes to Consolidated Financial Statements relate to the Company's continuing operations. The assets and liabilities of the discontinued operation after impairment, the revenues and expenses of the discontinued operation and a list of unusual expenses relating to the discontinued operation are shown below.

ASSETS AND LIABILITIES – DISCONTINUED

		December 31,	
		2012	2011
ASSETS			
CURRENT ASSETS:			
Cash and cash equivalents	\$	106,548	\$ 74,945
Restricted collateral deposits		44,827	193,488
Trade receivables.....		164,824	2,131,599
Other accounts receivable and prepaid expenses		73,073	133,149
Inventories.....		–	3,499,444
Total current assets		389,272	6,032,625
LONG TERM ASSETS:			
Severance pay fund		–	683,883
Total long term assets		–	683,883
Total assets	\$	389,272	\$ 6,716,508
LIABILITIES			
CURRENT LIABILITIES:			
Trade payables	\$	75,862	\$ 4,165,367
Other accounts payable and accrued expenses		453,443	2,250,584
Current portion of long term debt (building mortgage).....		59,287	401,600
Deferred revenues		–	489,416
Total current liabilities		588,592	7,306,967
LONG TERM LIABILITIES			
Long term debt (building mortgage)		912,813	963,814
Total long-term liabilities		912,813	963,814
Total liabilities	\$	1,501,405	\$ 8,270,781

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

REVENUE AND EXPENSES – DISCONTINUED

	December 31,	
	2012	2011
Revenues	\$ 6,890,664	\$ 17,411,879
Cost of revenues	6,476,082	15,924,925
Research and development expenses	–	643,201
Selling and marketing expenses	301,990	835,957
General and administrative expenses	493,868	2,504,746
Impairment of long lived assets	–	3,279,558
Amortization of intangible assets	–	13,350
Total operating costs and expenses	7,271,940	23,201,737
Operating loss	(381,276)	(5,789,858)
Other (income) expense	(288,594)	20,909
Financial expense, net	66,111	483,624
Loss from affiliated company	–	269,453
Total other expense	(222,483)	773,986
Loss before income tax benefit	(158,793)	(6,563,844)
Income tax benefit	–	–
Net loss	\$ (158,793)	\$ (6,563,844)
Loss on sale, net of \$0 income taxes	\$ (829,490)	\$ –

Non-recurring charges related to discontinued operations	Year ended December 31, 2011
Impairment of goodwill and intangibles	\$ 1,792,339
Impairment of property and equipment, net	1,487,219
Write off of affiliated company loan and investment	269,453
Additional special severance – Israel	301,876
Total	\$ 3,850,887

The Company retained the facility used by the Armor operations and currently leases it to the buyer of those operations under a three year operating lease for \$9,300 per month. The Company is marketing the facility for sale (it is included within Discontinued Operations), and it has no recorded book value as of December 31, 2012. The Company remains responsible for the outstanding mortgage on this facility, which was \$950,000 as of December 31, 2012 (as further described in Note 11), and which it expects to either transfer with the sale of the facility or pay off with the related sales proceeds plus other available cash resources as necessary.

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 are generated in U.S. dollars (“dollars”). In addition, a substantial portion of the Company’s costs are incurred in dollars. Management believes that the dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company including most of its subsidiaries is the dollar. Accordingly, monetary accounts maintained in currencies other than dollars are remeasured into dollars, with resulting gains and

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

losses reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

The majority of transactions of MDT (discontinued) and Epsilor-EFL are in New Israel Shekels (“NIS”) and a substantial portion of MDT’s and Epsilor-EFL’s costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT and Epsilor-EFL. Accordingly, the financial statements of MDT and Epsilor-EFL have been translated into 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 weighted average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive income (loss) in stockholders’ equity. All accumulated other comprehensive income related to the Armor Division, in the amount of \$189,969, was recorded as an adjustment to the loss on sale in discontinued operations. As of December 31, 2012, all accumulated other comprehensive income represents foreign currency translation adjustments.

c. Principles of consolidation:

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

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 collateral deposits are primarily invested in highly liquid deposits which are used as a security for the Company’s performance guarantees at FAAC and Epsilor-EFL.

f. Marketable securities:

The Company 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. Investment in securities 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. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of operations. The Company did not hold any marketable securities at either December 21, 2012 or 2011.

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 2012 and 2011, the Company wrote off \$57,000 and \$145,000, respectively, of obsolete inventory, 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 Law for the Encouragement of Capital Investments, 5719-1959 (the “Investments Law”). The Company did not receive any investment grants in 2012 and 2011.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

i. Revenue recognition:

The Company is a defense and security products and services company, engaged in two business areas: interactive simulation for military, law enforcement and commercial markets; and batteries and charging systems for the military. During 2012 and 2011, the Company recognized revenues (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 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 (iii) from the sale of lifejacket lights (Battery and Power Systems Division).

Revenues from products sold by the Battery and Power Systems Division are recognized when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probable, and no further obligation remains. Typically revenue is recognized, per the contract, when the transaction is entered into the U.S. Government's Wide Area Workflow system, which occurs after the products have been accepted at the plant or when shipped. Sales to other entities are recorded in accordance with the contract, either when shipped or delivered. Normally, in this division, there are no further obligations that would preclude the recognition of revenue.

Revenues from contracts in the Training and Simulation Division that involve customization of the system to customer specifications are recognized 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. 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. Normally there are no further obligations that would preclude the recognition of revenue.

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 that do not require significant customization are 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 Vendor Specific Objective Evidence ("VSOE") of fair value of

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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, customer prepayments and billing in excess of costs and estimated earnings on uncompleted contracts.

j. Warranty:

The Company typically offers a one to two 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, and records deferred revenue in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty costs 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. (See Note 17.)

k. Research and development cost:

The Company capitalizes certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products are generally charged to expenses as incurred. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release have been capitalized. Capitalized software costs will be amortized by the greater of the amount computed using: (i) the 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 (one to three 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, 2012.

In 2012 and 2011, the Training and Simulation Division capitalized approximately \$335,000 and \$406,000, respectively, in software development costs that will be amortized on a straight-line method over 2 years, the useful life of the software.

l. Income taxes:

The Company accounts for income taxes under the asset and liability method, whereby deferred tax assets and liability account balances are determined based on tax credit carryforwards and differences between the financial reporting and the tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

The Company has adopted the provisions of the FASB ASC 740-10. FASB ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. Uncertain tax positions require determinations and estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If the Company's determinations and estimates prove to be inaccurate, the resulting adjustments could be material to the Company's future financial statements.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

m. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, restricted collateral deposits and trade receivables. Cash and cash equivalents are invested mainly in U.S. dollar deposits with 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 are mainly derived from sales to customers located primarily in the United States and Israel along with the countries listed in footnote 16.c. 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 had no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

n. 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 common stock equivalents related to outstanding stock options, non-vested restricted stock, warrants and convertible debt. All common stock equivalents 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 common stock equivalents excluded from the calculations of diluted net loss per share was 614,968 and 701,411 for the years ended December 31, 2012 and 2011, respectively.

o. Accounting for stock-based compensation

Stock-based awards to employees are recognized as compensation expense based on the calculated fair value on the date of grant. The Company determines the fair value of options using the Black-Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term.

The Company did not grant any options in 2012 or 2011. The Company assumed a 20% forfeiture rate on existing options for both years. The Company typically uses a 5-10% forfeiture rate for restricted stock and restricted stock units and adjusts both forfeiture rates based on historical forfeitures. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock.

p. Fair value of financial instruments:

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

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

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

The fair values of long-term promissory notes are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. The carrying amount of the long-term liabilities approximates their fair value (Level 3).

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

q. 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 held by insurance companies on behalf of the employees, insurance policies and by accrual. The fair value of these funds, which are considered Level 2 fair value measurements, is recorded as an asset in the Company's balance sheet.

In addition, 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. As of December 31, 2012, the Company had made a provision of \$217,733 for this special severance pay. As of December 31, 2012 and 2011, the unfunded severance pay in that regard amounted to \$1,267,844 and \$1,050,111, respectively.

Pursuant to the terms of the respective employment agreements between the Company and its Chief Executive Officer and its President, funds to secure payment of their respective contractual severance amounts are to be deposited for their benefit, with payments to be made pursuant to an agreed-upon schedule. 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 and losses 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 fair value of the deposited funds is based on the cash surrender value of these policies and includes immaterial profits.

In April 2009, the Company, with the agreement of its Chief Executive Officer and its President, funded an additional portion of their severance security by means of issuing to them, in trust, restricted stock having a value (based on the closing price of the Company's stock on the Nasdaq Stock Market on the date on which the executives and the Company's board of directors agreed to this arrangement) of \$440,000, a total of 602,740 shares. The Company agreed with the executives that the economic risk of gain or loss on these shares is to be borne by them. Should they leave the Company's employ under circumstances in which they are not entitled to their severance package (primarily, termination for Cause as defined in their employment agreement), these shares would be returned to the Company for cancellation and because of this, these shares are not included in the basic EPS calculation.

Severance expenses for continuing operations for the years ended December 31, 2012 and 2011 amounted to \$19,216 and \$249,010, respectively.

r. Advertising costs:

The Company records advertising costs as incurred. Advertising expense for the years ended December 31, 2012 and 2011 was approximately \$155,887 and \$166,701, respectively.

s. New accounting pronouncements:

Effective January 1, 2011, the Company adopted ASU 2009-13, "Revenue Recognition (Accounting Standards Codification ASC 605 – Multiple-Deliverable Revenue Arrangements)" and ASU 2009-14, "Software ASC 985 – Certain Revenue Arrangements That Include Software Elements." ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: i) VSOE or ii) third-party evidence ("TPE"), before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities are required to estimate the selling prices of those elements. Overall arrangement consideration is allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has

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

been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. Additionally, ASU 2009-14 provides guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software that is not essential to the product's functionality. ASU 2009-14 requires the same expanded disclosures that are included within ASU 2009-13. The impact of adoption did not have a significant impact on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, "Comprehensive Income (Topic 220) — Presentation of Comprehensive Income." ASU 2011-05 eliminates the current option to report other comprehensive income and its components in the statement of changes in stockholders' equity and requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The Company adopted the disclosure standard in January 2012.

In July 2012, the FASB issued ASU 2012-02 "Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment" ("ASU 2012-02"). ASU 2012-02 permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test. Under the amendments in ASU 2012-02, an entity is not required to calculate the fair value of an indefinite-lived intangible asset unless it determines that it is more likely than not that the fair value of the asset is less than its carrying amount. An entity also will have the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. ASU 2012-02 is effective for interim and annual indefinite-lived intangible asset impairment tests performed for fiscal years beginning on or after September 15, 2012, with early adoption permitted. The Company's adoption of ASU 2012-02 is not expected to have a material impact on its consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This ASU is intended to improve the reporting of reclassifications out of accumulated other comprehensive income. The ASU requires an entity to report, either on the face of the statement where net income is presented or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in their entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in this ASU apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP and that report items of other comprehensive income. For public entities, the amendments in this ASU are effective prospectively for reporting periods beginning after December 15, 2012. The impact of adoption of this ASU by the Company is not expected to be material.

No other new accounting pronouncements issued or effective during 2012 have had or are expected to have a significant impact on the Company's consolidated financial statements.

t. Share repurchase:

In February 2009, the Company's Board of Directors authorized the repurchase in the open market or in privately negotiated transactions of up to \$1,000,000 of the Company's common stock. Through December 31, 2012, the Company repurchased 638,611 shares for a total of \$869,931. The repurchase program, which expires on August 13, 2013, is subject to management's discretion.

u. Reclassification:

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

AROTECH CORPORATION AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 3: – RESTRICTED COLLATERAL DEPOSITS

	December 31,	
	2012	2011
Deposits in connection with Epsilor projects	\$ 40,164	\$ 39,239
Deposits in connection with FAAC projects	146,142	1,640,370
Total restricted collateral deposits	<u>\$ 186,306</u>	<u>\$ 1,679,609</u>

NOTE 4:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

The following is a summary of other accounts receivable and prepaid expenses as of December 31, 2012 and 2011:

	December 31,	
	2012	2011
Government authorities	\$ 101,509	\$ 405,961
Employees	184,423	131,764
Prepaid expenses	552,568	746,331
Other	340,280	169,096
Total	<u>\$ 1,178,780</u>	<u>\$ 1,453,152</u>

NOTE 5:– INVENTORIES

	December 31,	
	2012	2011
Raw and packaging materials	\$ 7,455,426	\$ 7,688,821
Work in progress	363,415	1,025,030
Finished products	2,214,684	789,320
Total	<u>\$ 10,033,525</u>	<u>\$ 9,503,171</u>

NOTE 6:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2012	2011
Cost:		
Computers and related equipment	\$ 2,290,850	\$ 2,247,918
Motor vehicles	492,584	443,483
Office furniture and equipment	1,068,526	1,229,241
Machinery, equipment and installations	5,755,750	5,193,498
Buildings	1,376,036	1,350,820
Land	300,000	300,000
Leasehold improvements	1,107,649	1,030,546
Demo inventory	1,617,416	1,605,494
	<u>14,008,811</u>	<u>13,401,000</u>
Accumulated depreciation:		
Computers and related equipment	2,102,237	2,015,704
Motor vehicles	186,224	119,699
Office furniture and equipment	956,471	1,030,360
Machinery, equipment and installations	4,119,078	3,645,155
Buildings	82,103	20,257
Leasehold improvements	828,920	761,429
Demo inventory	1,269,198	1,177,389
	<u>9,544,231</u>	<u>8,769,993</u>
Property and equipment, net	<u>\$ 4,464,580</u>	<u>\$ 4,631,007</u>

b. Depreciation expense amounted to \$1,087,178 and \$1,103,943 for the years ended December 31, 2012 and 2011, respectively.

AROTECH CORPORATION AND ITS SUBSIDIARIES
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NOTE 6:– PROPERTY AND EQUIPMENT, NET (Cont.)

As for liens, see Note 10.d.

NOTE 7:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

The Company allocates goodwill acquired in a business combination to the appropriate reporting unit as of the acquisition date. Currently, the Company's reporting units are also its reportable segments and the associated goodwill was determined when the specific businesses in the reportable segments were purchased.

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

	December 31, 2011	Additions	Adjustments (currency)	December 31, 2012
Training and Simulation Division	\$ 24,435,641	\$ –	\$ –	\$ 24,435,641
Battery and Power Systems Division	5,985,557	–	141,100	6,126,657
Total	<u>\$ 30,421,198</u>	<u>\$ –</u>	<u>\$ 141,100</u>	<u>\$ 30,562,298</u>

b. Other intangible assets:

		December 31,			
		2012		2011	
	Useful life	Cost	Net book value	Cost	Net book value
Technology	4-8 years	\$ 6,788,000	\$ 189,429	\$ 6,788,000	\$ 284,143
Capitalized software costs	1-3 years	3,690,416	491,433	3,355,716	616,819
Trademarks	10 years	28,000	14,000	28,000	16,800
Backlog/customer relationship	1-10 years	744,000	31,000	744,000	37,200
Customer list	2-10 years	6,773,645	621,740	6,773,645	1,243,480
		18,024,061	<u>\$ 1,347,602</u>	17,689,361	<u>\$ 2,198,442</u>
Exchange rate differences		91,671		155,663	
Less – accumulated amortization		<u>(16,676,459)</u>		<u>(15,490,920)</u>	
Amortized cost		1,439,273		2,354,104	
Trademarks (indefinite lives)		799,000		799,000	
Net book value		<u>\$ 2,238,273</u>		<u>\$ 3,153,104</u>	

Amortization expense amounted to \$1,185,539 and \$1,905,097 for the years ended December 31, 2012 and 2011, respectively, including amortization of capitalized software costs of \$460,085 and \$603,393, respectively.

c. Estimated amortization expenses for the years ended:

	Year ended December 31,
2013	\$ 1,089,442
2014	231,160
2015	27,000
2016	–
Total	<u>\$ 1,347,602</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 income on the Balance Sheet.

NOTE 8:– SHORT-TERM BANK CREDIT AND LOANS

The Company has \$10,723,000 authorized in credit lines from certain banks, of which \$723,000 is denominated in NIS (\$168,000 was outstanding as of December 31, 2012) and carries various interest rates up to 8.2%. The primary line of \$10,000,000, subject to borrowing base limitations and outstanding letters of credit, is denominated in U.S. dollars. This line carries an interest rate of 30 day LIBOR plus 375 basis points which was 3.96% as of December 31, 2012. As of December 31, 2012, \$9,620,000 was borrowed under the Company's primary line. Approximately \$380,000 of credit on the primary line was available at December 31, 2012. The Company's primary credit facility and the Company's building mortgage with the

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NOTE 8:– SHORT-TERM BANK CREDIT AND LOANS (Cont.)

same bank contains certain covenants, including limiting the Company's distributions to Arotech affiliates to \$4,000,000, and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0. The Company was in compliance with both of these covenants at December 31, 2012. Additionally, the loan is collateralized by the assets of Arotech and its subsidiaries.

In February 2013, to support the Company's growth, our primary bank increased the Company's credit line by 50%, from \$10,000,000 to \$15,000,000, and the expiration of the credit line was extended to May 31, 2015. The new credit agreement carries an interest rate of 30 day LIBOR plus 375 basis points and an unused line of credit fee of 0.35%. The new credit agreement also contains certain covenants, which are measured on a rolling twelve-month basis, limiting the Maximum Increase in Net Advance to Affiliates to less than 90% of EBITDA and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0. It is expected that the Company will be in compliance with these covenants during 2013.

Previously, the Company had a \$10.0 million credit facility with another bank that expired April 30, 2012 and a building mortgage with the same bank which contained certain covenants, including limiting the Company's distributions to Arotech affiliates, limiting the Company's operating cash flow to total fixed charges to a ratio of 1.25 to 1.00 and limiting the Company's total liabilities to adjusted tangible net worth to a ratio of 2.50 to 1.00.

NOTE 9:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

The following is a summary of other accounts payable and accrued expenses as of December 31, 2012 and 2011:

	December 31,	
	2012	2011
Employees and payroll accruals	\$ 3,003,048	\$ 2,083,209
Accrued vacation pay	811,910	758,093
Accrued expenses	369,800	530,079
Government authorities	68,152	262,752
Total	<u>\$ 4,252,910</u>	<u>\$ 3,634,133</u>

NOTE 10:– COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

Under Epsilor-EFL's research and development agreements with the Office of the Chief Scientist ("OCS"), and pursuant to applicable laws, Epsilor-EFL is required to pay royalties at the rate of 3%-3.5% of net sales of products developed with funds provided by the OCS, up to an amount equal to 100% of research and development grants received from the OCS. (Amounts due in respect of projects approved after 1999 also bear interest at the LIBOR rate.) Epsilor-EFL is obligated to pay royalties only on sales of products in respect of which OCS participated in their development. Should the project fail, Epsilor-EFL will not be obligated to pay any royalties or refund the grants.

Royalties paid or accrued for the years ended December 31, 2012 and 2011 to the OCS amounted to zero and \$1,946, respectively.

b. Lease commitments:

The Company rents its 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:

Minimum rental payments	December 31
2013	\$ 860,306
2014	441,333
2015	362,624
2016	366,959
2017	371,294
Thereafter	98,266
Total	<u>\$ 2,500,782</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

Total rent expenses for the years ended December 31, 2012 and 2011 were \$924,864 and \$901,216, 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 property and equipment.

The table below details the original value, accumulated depreciation and net book value of the assets included.

<u>Leased Assets</u>	<u>December 31,</u>	
	<u>2012</u>	<u>2011</u>
Equipment	\$ 77,654	\$ 77,654
Less: Accumulated depreciation	(77,654)	(52,164)
Net book value	<u>\$ –</u>	<u>\$ 25,490</u>

There are no remaining capital lease obligations.

c. Guarantees:

The Company obtained bank guarantees in the amount of \$427,783 in connection with (i) obligations of one of the Company's subsidiaries to the Israeli customs authorities, and (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.

d. Liens:

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

The Company has \$723,000 in credit liens collateralized by the assets of the Company and guaranteed by the Company.

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

e. Litigation and other claims:

As of the date of this filing, there were no material pending legal proceedings against the Company.

NOTE 11:– LONG TERM DEBT

a. Subordinated convertible notes due August 15, 2011

In August 2008, the Company issued \$5,000,000 in 10% subordinated convertible notes due August 15, 2011 (the "Notes"). The Notes were convertible at the option of the holders at a fixed conversion price of \$2.24. The principal amount of the Notes was 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 were met. The failure to meet such conditions could have made the Company unable to pay its Notes, causing it to default.

As of December 31, 2011, the Notes were paid in full and all associated warrants had expired.

b. Mortgage Note, Ann Arbor, Michigan:

In July 2011, the Simulation and Training Division purchased a building for \$1,500,000 containing both office and lab space. The building was financed with a \$1,100,000 mortgage loan that was obtained through the Company's primary bank. The note requires a payment (principal and interest) of approximately \$8,000 per month at an interest rate of LIBOR plus 375 basis points per annum with a balloon payment due in May 2017. In December 2012, FAAC leased surplus space of the purchased building to a non-profit organization for \$6,300 per month as office space for a term of 10 years with an option to terminate the lease with a one year prior notice in May 2018. (See Note 8 for the relevant covenants relating to the mortgage.)

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:-- LONG TERM DEBT (Cont.)

c. Mortgage Note, Auburn, Alabama:

In March 2007, the Company purchased space for the now-discontinued Armor Division in Auburn, Alabama for approximately \$1,100,000 pursuant to a seller-financed secured purchase money mortgage. Half the mortgage is payable over ten years in equal monthly installments based on a 20-year amortization of the full principal amount, and the remaining half is payable at the end of ten years in a balloon payment. The note requires a payment (principal and interest) of approximately \$9,300 per month at an interest rate of 8.0% per annum. The Company is currently leasing this building to the buyer of the Armor Division for approximately \$9,300 per month under a three year lease.

d. Term loans, Israel:

In February 2012, the Company negotiated a short term loan with a local bank in Israel. The funds were released to the Company in three tranches of \$250,000 each in February, March and April 2012. The interest rate for this loan is prime plus 1.2% and will be repaid in three tranches in February, March and April 2013. The balance of this loan as of December, 2012 was \$811,834. The Company has additional long term debt outstanding of approximately \$2,000 for a vehicle loan. This amount is payable in 2013.

e. Minimum loan payments:

	Continuing	Discontinued
Minimum loan payments	December 31	
2013	\$ 888,839	\$ 59,287
2014	55,000	40,382
2015	55,000	43,734
2016	55,000	47,356
2017	55,000	781,341
Thereafter	772,917	—
Total	<u>\$ 1,881,756</u>	<u>\$ 972,100</u>

NOTE 12:-- COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Billings in excess of costs generated under the percentage-of-completion method are recorded as deferred revenues until the revenue recognition criteria are met. Deferred revenues include unearned amounts received under maintenance and support services, customer deposits of \$16,202 and \$55,201 for 2012 and 2011 respectively, and billing in excess of costs and estimated earnings on uncompleted contracts.

The following is a summary of the costs and estimated earnings on uncompleted contracts as of December 31, 2012 and 2011. Open contracts are expected to be completed in the following year. The billings in excess of costs are included in the deferred revenue line of the balance sheet:

	Year ended December 31,	
	2012	2011
Costs incurred on uncompleted contracts	\$ 111,128,026	\$ 82,310,317
Estimated earnings	18,649,855	18,064,955
	129,777,881	100,375,272
Less billings to date	(117,503,299)	(96,059,555)
Total	<u>\$ 12,274,582</u>	<u>\$ 4,315,717</u>
Unbilled receivables	\$ 13,374,004	\$ 5,722,781
Billings in excess of costs (included in deferred revenues)	(1,099,422)	(1,407,064)
Total	<u>\$ 12,274,582</u>	<u>\$ 4,315,717</u>

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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

b. Warrants:

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. Due to certain exercise price reset provisions, the warrants were accounted for as liabilities at fair value with changes in fair value reflected as financial income or expense.

The Notes were fully paid and the warrants expired unexercised on August 15, 2011.

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

1. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 400,307 were available for future grants to outside directors as of December 31, 2012.

2. 2009 Equity Incentive Plan – 5,000,000 shares reserved for issuance, of which 3,265,555 were available for future grants to employees and consultants as of December 31, 2012.

3. 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 and restricted stock units also generally vest after three years or pursuant to defined performance criteria; in the event that employment is terminated within that period, unvested restricted shares and restricted stock units generally revert back to the Company.

4. Deferred stock compensation is amortized and recorded as compensation expense ratably over the vesting period of the option or the restriction period of the restricted shares and restricted stock units. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options, restricted shares and restricted stock units to employees and directors in 2012 and 2011 was \$447,680 and \$408,492, respectively. The calculated intrinsic value of vested and unvested options for 2012 and 2011 was zero.

5. A summary of the status of the Company's plans and other share options, restricted shares and restricted stock units granted as of December 31, 2012 and 2011, and changes during the years ended on those dates, is presented below:

Stock Options:

	2012		2011	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
Options outstanding at beginning of year	64,953	\$ 7.80	186,714	\$ 6.36
Changes during year:				
Granted	—	\$ —	—	\$ —
Exercised	—	\$ —	—	\$ —
Forfeited	(52,725)	\$ 8.34	(121,761)	\$ 5.60
Options outstanding at end of year	12,228	\$ 5.46	64,953	\$ 7.80
Options vested at end of year	12,228	\$ 5.46	64,953	\$ 7.80

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

Restricted Shares and Restricted Stock Units:

	2012		2011	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
Non-vested at the beginning of the year	636,488	\$ 1.43	406,813	\$ 1.60
Changes during year:				
Restricted stock granted	517,582	\$ 1.17	414,284	\$ 1.32
Restricted units granted	60,000	\$ 1.67	120,000	\$ 1.67
Vested	(310,497)	\$ 1.29	(304,609)	\$ 1.47
Forfeited	(59,303)	\$ 1.49	—	\$ —
Non-vested at the end of the year	844,270	\$ 1.30	636,488	\$ 1.43
Restricted shares vested at end of year	2,353,996	\$ 1.97	2,043,499	\$ 2.07

6. The remaining total compensation cost related to non-vested restricted share and restricted stock unit awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2012 was \$327,750. The weighted average period over which this compensation cost is expected to be recognized is approximately two years.

7. On January 1, 2009, the Company adopted FASB ASC 260-45-28, Share-Based Payment Arrangements, 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 diluted earnings per share using the two class method. The Company has determined that the unvested restricted stock issued to our employees and directors are "participating securities" and as such, are included, net of estimated forfeitures, in the total shares used to calculate the Company's diluted loss per share unless a net loss is reported, in which situation unvested stock awards are excluded from the number of shares outstanding for both basic and diluted earnings per share calculations.

NOTE 14:- INCOME TAXES

a. General:

As of December 31, 2012, Arotech had net operating loss carryforwards for U.S. federal income tax purposes of \$43,300,000, which are available to offset future taxable income, if any, expiring in 2020 through 2032. Utilization of U.S. net operating losses is subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

At December 31, 2012, the Company had net deferred tax assets before valuation allowance of \$43,942,000. 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 allowance 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 IRC Section 382 changes that have occurred. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance.

The Company has indefinite-lived intangible assets consisting of trademarks and goodwill. These 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.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

Due to the fact that the aforementioned deferred tax liability could have an indefinite life, it is not netted against the Company's deferred tax assets when determining the required valuation allowance. Doing so would result in the understatement of the valuation allowance and related deferred income tax expense.

The Company has also reevaluated its income tax positions under FASB ASC 740-10 as of December 31, 2012 and the Company believes that it has no material uncertain tax positions and therefore has no uncertain tax position reserves and does not expect to provide for any such reserves. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. It is the Company's policy that any assessed penalties and interest on uncertain tax positions would be charged to income tax expense.

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

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 2009, although carryforward losses that were generated prior to 2010 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 2007.

The Company files consolidated tax returns for its U.S. entities.

b. Israeli subsidiary (Epsilor-EFL):

Effective January 1, 2011 Epsilor-EFL's tax rate was 10% in 2011 and 2012 and will be reduced to 6% by 2015. In addition, dividends paid from the profits of Epsilor-EFL are subject to tax at the rate of 15% in the hands of their recipient and tax exempt on dividends paid to Israeli company. As of December 31, 2012, there are no tax exempt profits earned by Epsilor-EFL by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2012. Furthermore, management has indicated that it has no intention of declaring any dividend.

c. Merger of Epsilor and EFL:

On June 25, 2009, two of the Company's Israeli subsidiaries, Epsilor and EFL, entered into a merger agreement pursuant to which EFL merged all of its assets and liabilities into Epsilor, with Epsilor the survivor of the merger (the "Merged Company").

Through the merger date, EFL accumulated certain tax losses (the "EFL Loss"). 20% of the EFL Loss was cancelled and is not available to offset any future income. The remaining amount of the EFL Loss (the "Remaining Loss") was absorbed into the Merged Company and is available to offset the Merged Company's income after July 1, 2009; provided that for the 16 tax years following the merger, losses will not be available to offset the Merged Company's income in excess of the lesser of (i) 6.25% of the original amount of the Remaining Loss, or (ii) 50% of the Merged Company's total taxable income in that year prior to giving effect to the application of any of the EFL Loss.

As of December 31, 2012, the Merged Company has tax loss carryforwards, generated by EFL, of \$84,000,000, which is available indefinitely to offset future taxable income.

d. Consolidated deferred income taxes:

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

	December 31,	
	2012	2011
U.S. operating loss carryforward	\$ 17,286,287	\$ 16,420,226
Foreign operating loss carryforward	21,366,068	20,938,603
Total operating loss carryforward	38,652,355	37,358,829
Temporary differences:		
Compensation and benefits	2,026,176	1,895,519
Warranty reserves	1,005,118	1,033,796
Foreign temporary differences	797,247	948,720
All other temporary differences	1,461,543	2,443,919
Total temporary differences	5,290,084	6,321,954
Deferred tax asset before valuation allowance	43,942,439	43,680,783
Valuation allowance	(43,942,439)	(43,680,783)
Total deferred tax asset	\$ –	\$ –
Deferred tax liability	\$ 4,920,021	\$ 4,321,521

The Company provided valuation allowances for the 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 operating loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance during 2012 was \$261,000.

e. Loss from continuing operations before taxes on income are as follows:

	Year ended December 31	
	2012	2011
Domestic	\$ 260,481	\$ (1,965,158)
Foreign	(1,660,719)	(1,389,392)
	\$ (1,400,238)	\$ (3,354,550)

f. Taxes on income were comprised of the following:

	Year ended December 31	
	2012	2011
Current federal taxes	\$ –	\$ –
Current state and local taxes	29,656	(69,734)
Deferred taxes	598,500	1,678,345
Expense	\$ 628,156	\$ 1,608,611
Domestic	\$ 628,156	\$ 959,027
Foreign	–	649,584
Expense	\$ 628,156	\$ 1,608,611

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:-- INCOME TAXES (Cont.)

	Year ended December 31,	
	2012	2011
Loss from continuing operations before taxes	<u><u>\$ (1,400,238)</u></u>	<u><u>\$ (3,354,550)</u></u>
Statutory tax rate	<u>34%</u>	<u>34%</u>
Theoretical income tax on the above amount at the U.S. statutory tax rate	\$ (476,081)	\$ (1,140,547)
Deferred taxes for which valuation allowance was provided	860,390	2,685,812
Non-deductible credits	64,726	8,035
State taxes, net of federal benefit	29,656	(69,734)
Foreign income in tax rates other than U.S. rate	<u>149,465</u>	<u>125,045</u>
Actual tax expense (benefit)	<u><u>\$ 628,156</u></u>	<u><u>\$ 1,608,611</u></u>

NOTE 15:-- SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expense), net:

	Year ended December 31,	
	2012	2011
Financial expenses:		
Interest, bank charges and fees	\$ (588,678)	\$ (350,330)
Debt discount amortization	—	(39,351)
Foreign currency transaction differences	(9,701)	(279,190)
Other	<u>(15,668)</u>	<u>(4,473)</u>
Total financial expenses	<u>(614,047)</u>	<u>(673,344)</u>
Financial income:		
Interest	—	114,925
Foreign currency transaction differences	66,061	208
Change in derivative values	—	226,954
Other	<u>—</u>	<u>251</u>
Total financial income	<u>66,061</u>	<u>342,338</u>
Total financial income (expense), net	<u><u>\$ (547,986)</u></u>	<u><u>\$ (331,006)</u></u>

NOTE 16:-- SEGMENT INFORMATION

a. General:

The Company operates in two continuing business segments (see Note 1.a. for a brief description of the Company's business).

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 on two primary factors: the segment's operating income and the segment's contribution to the Company's future strategic growth.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:- SEGMENT INFORMATION (Cont.)

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

	Training and Simulation Division	Battery and Power Systems Division	Corporate Expenses	Discontinued operations	Total Company
2012					
Revenues from outside customers	\$ 59,270,768	\$ 20,779,666	\$ —	\$ —	\$ 80,050,434
Depreciation and amortization expenses ⁽¹⁾	(1,105,958)	(1,118,104)	(48,655)	—	(2,272,717)
Direct expenses ⁽²⁾	(53,055,151)	(19,974,339)	(5,600,479)	—	(78,629,969)
Segment net income (loss)	5,109,659	(312,777)	(5,649,134)	—	(852,252)
Financial expenses	(43,221)	(7,639)	(497,126)	—	(547,986)
Income tax expense (benefit)	(7,688)	—	635,844	—	628,156
Net income (loss) – continuing operations	5,074,126	(320,416)	(6,782,104)	—	(2,028,394)
Net loss – discontinued operations	—	—	—	(988,283)	(988,283)
Net income (loss)	<u>\$ 5,074,126</u>	<u>\$ (320,416)</u>	<u>\$ (6,782,104)</u>	<u>\$ (988,283)</u>	<u>\$ (3,016,677)</u>
Segment assets	<u>\$ 51,302,000</u>	<u>\$ 26,013,955</u>	<u>\$ 174,791</u>	<u>\$ 389,272</u>	<u>\$ 77,880,018</u>
Additions to long-lived assets	<u>\$ 550,634</u>	<u>\$ 734,198</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1,284,832</u>
2011					
Revenues from outside customers	\$ 42,881,573	\$ 19,254,005	\$ —	\$ —	\$ 62,135,578
Depreciation and amortization expenses ⁽¹⁾	(1,845,582)	(1,094,930)	(68,528)	—	(3,009,040)
Direct expenses ⁽²⁾	(38,292,715)	(18,297,385)	(5,559,982)	—	(62,150,082)
Segment net income (loss)	2,743,276	(138,310)	(5,628,510)	—	(3,023,544)
Financial expenses	(47,112)	(209,764)	(74,130)	—	(331,006)
Income tax expense (benefit)	(69,734)	646,824	1,031,521	—	1,608,611
Net income (loss) – continuing operations	2,765,898	(994,898)	(6,734,161)	—	(4,963,161)
Net loss – discontinued operations	—	—	—	(6,563,844)	(6,563,844)
Net income (loss)	<u>\$ 2,765,898</u>	<u>\$ (994,898)</u>	<u>\$ (6,734,161)</u>	<u>\$ (6,563,844)</u>	<u>\$ (11,527,005)</u>
Segment assets	<u>\$ 48,501,634</u>	<u>\$ 25,335,086</u>	<u>\$ 548,717</u>	<u>\$ 6,716,508</u>	<u>\$ 81,101,945</u>
Additions to long-lived assets	<u>\$ 2,124,953</u>	<u>\$ 911,382</u>	<u>\$ 3,345</u>	<u>\$ 97,558</u>	<u>\$ 3,137,238</u>

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

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

c. Summary information about geographic areas:

The following presents total revenues according to the locations of the Company's end customers and long-lived assets as of and for the years ended December 31, 2012 and 2011:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:- SEGMENT INFORMATION (Cont.)

	2012		2011	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets
U.S.A.	\$ 63,751,882	\$ 28,879,572	\$ 45,517,776	\$ 29,543,962
Israel	7,485,034	8,385,579	8,585,357	8,661,347
Germany	1,517,200	—	318,892	—
Taiwan	1,349,420	—	1,915,361	—
Korea	1,198,663	—	—	—
Canada	1,167,656	—	2,150,419	—
Hong Kong	1,098,346	—	—	—
India	605,966	—	8,630	—
Mexico	283,584	—	150,634	—
Ecuador	139,845	—	—	—
Thailand	137,970	—	72,363	—
U.A.E.	109,604	—	386,241	—
China	98,832	—	307,120	—
New Zealand	—	—	731,151	—
Kuwait	—	—	539,118	—
England	—	—	228,669	—
Slovenia	—	—	121,475	—
Other	1,106,432	—	1,102,372	—
	<u>\$ 80,050,434</u>	<u>\$ 37,265,151</u>	<u>\$ 62,135,578</u>	<u>\$ 38,205,309</u>

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

Other than for sales to various branches of the United States Military, which accounted for 54% and 46% of consolidated continuing revenues for 2012 and 2011, respectively, no single customer accounted for more than 10% of revenues for either year.

e. Revenues from major products:

	Year ended December 31,	
	2012	2011
Water activated batteries	\$ 3,786,946	\$ 3,614,876
Batteries and chargers	16,992,720	15,639,129
Simulators	59,270,768	42,881,573
Total	<u>\$ 80,050,434</u>	<u>\$ 62,135,578</u>

NOTE 17:- WARRANTY

The following is a summary of the deferred warranty revenue included in total deferred revenue as of December 31, 2012 and 2011:

	Year ended December 31,	
	2012	2011
Balance at beginning of period	\$ 2,557,160	\$ 3,236,122
Deferred revenue	2,396,807	1,960,540
Revenue recognized	(2,271,505)	(2,639,502)
Balance at end of period	<u>\$ 2,682,462</u>	<u>\$ 2,557,160</u>

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2012 and 2011

Description	Balance at beginning of period	Reductions	Additions	Balance at end of period
Year ended December 31, 2012				
Allowance for doubtful accounts.....	\$ –	\$ –	\$ –	\$ –
Valuation allowance for deferred taxes*	43,681,000	–	261,000	43,942,000
Year ended December 31, 2011				
Allowance for doubtful accounts.....	\$ –	\$ –	\$ –	\$ –
Allowance for settlements	1,553,000	(1,553,000)	–	–
Valuation allowance for deferred taxes*	36,629,000	–	7,052,000	43,681,000

* The 2012 and 2011 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
*Director and Chief Science Officer,
Lucid, Inc.*

Steven Esses, Director
*President,
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*

Arthur S. Leibowitz, Director
*Lecturer,
Adelphi University School of Business*

AROTECH CORPORATE OFFICERS

Robert S. Ehrlich
Chairman and Chief Executive Officer

Steven Esses
President

Dean Krutty
President, Training and Simulation Division

Ronen Badichi
President, Battery and Power Systems Division

Thomas J. Paup
Senior Vice President – Finance and CFO

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

Norman Johnson
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Tuesday, November 12, 2013, at 11:00 a.m. local time at the offices of Lowenstein Sandler P.C., 1251 Avenue of the Americas, 17th 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.



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