Annual Report




2002

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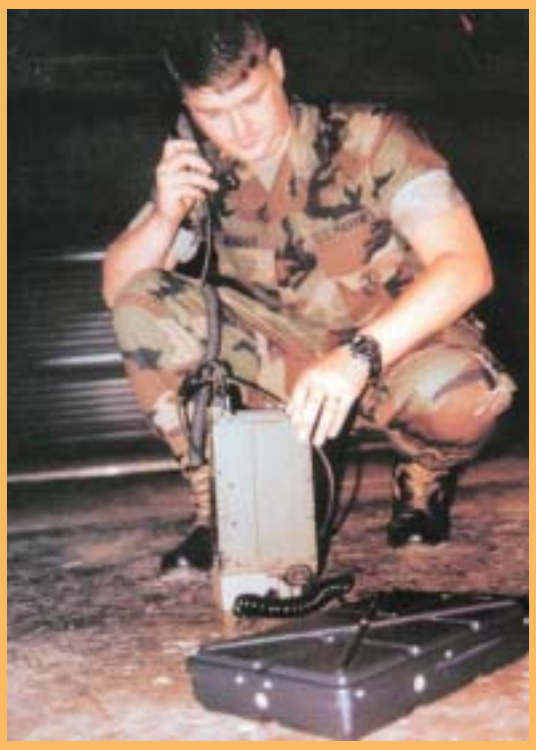
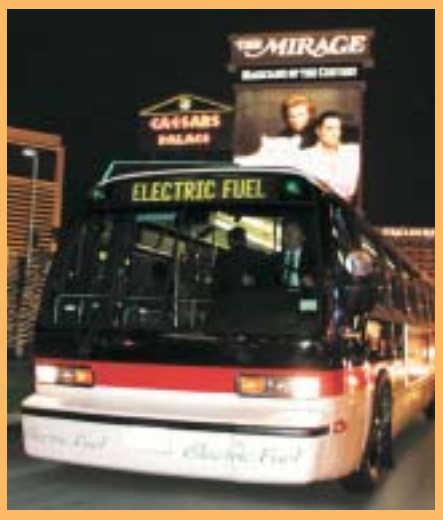


High Power Zinc-Air Batteries

Lifejacket Lights



Zinc-Air Zero Emission Electric Transit Buses

Electric Fuel®

An AROTECH Company

Annual Report 2002

Defense & Security Zinc-Air Batteries for Military Applications Interactive Simulators Vehicle Armoring Batteries for Electric Vehicles Multimedia Trainers Lifejacket Lights Portable Power Systems for Homeland Security **Defense & Security** Zinc-Air Batteries for Military Applications Interactive Simulators Vehicle Armoring Batteries for Electric Vehicles Multimedia Trainers Lifejacket Lights Portable Power Systems for Homeland Security **Defense & Security**

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The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003.

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.*

August 2003

Dear Fellow Shareholder,

This past year was a year of significant achievements for our Company. The dramatic course correction we took in 2002 was a difficult step to take, but it was essential to putting our Company on the road to profitability. In 2002, we transformed our Company from a foundering development enterprise to a promising and growing defense and security company. To further emphasize our new direction, we changed our name to Arotech Corporation. We now have a clear path to cash profitability and, with dedication and determination, we expect to complete the turnaround this year.

In the third quarter of 2002 we took a number of steps that we felt were essential to the future of our Company. The most significant step was the recognition that we could no longer sustain the high costs of the consumer battery business. While we developed wonderful products in our Instant Power brand of disposable cell phone, PDA, camcorder and digital camera batteries, production and marketing costs – coupled with the slow rate of consumer acceptance – made the enterprise unfeasible.

Failing to take the painful steps of discontinuing the consumer battery business, terminating more than 60 employees, (with their related severance costs) and writing off the related equipment and inventory would have bought the Company to the brink of bankruptcy. Unwillingness to make these difficult decisions was part of the background for the Board's accepting the resignation of our former President and CEO.

Our leading-edge advanced zinc air battery technology is now focused on a ready and open market: military and homeland security applications. After several years of intense development of our batteries for the U.S. Army's Communications-Electronics Command (CECOM), we were awarded $4.1 million in contracts for our BA-8180. This is the first time the U.S. Army has ever assigned an official "BA" battery designation to a zinc-air battery, and we see this as the start of significant growth in the sales of our batteries to the military. We are also continuing the development of a battery system to power an Unmanned Arial Vehicle (UAV) for the U.S. military and a Micro Arial Vehicle (MAV) for the Israeli military.

We took two additional important steps in July 2002 that were critical to the solid repositioning of our Company in the defense and security business:

- We purchased 100% of IES Interactive Training, Inc. IES is a world-leading manufacturer of hi-tech multimedia and interactive digital training solutions, supplying systems to corporations, government agencies and military and law enforcement professionals around the globe. Through the use of a unique solution-driven software and an experienced team of interdisciplinary professionals, IES has assumed a leadership role in delivering products that set the industry standard for interactive simulation training systems.
- We acquired a 51% controlling share in MDT Protective Industries, Ltd. – a leader in state-of-the-art lightweight armoring of vehicles, ranging from light tactical vehicles to passenger vehicles. With years of battlefield experience in Israel, MDT-armored vehicles have provided life-saving protection for their passengers.

Both companies are leaders in their market niches and have attractive growth prospects. MDT had a record year in 2002 and plans to open a plant in the U.S. in 2003 to serve the U.S. domestic security and other markets, as well as to qualify for Israeli contracts funded by funds from the Treasury Department's Financial Management Service (FMS), which are required to be spent in the U.S. IES also had a record year, and with its expansion into Europe with the German police order, the outlook for a record-breaking 2003 seems very achievable.

For 2003, Arotech is striving to reach cash flow breakeven and head to profitability. We appreciate the support of our shareholders and associates and look forward to significant performance in 2003.

Sincerely,

Robert S. Ehrlich
Chairman, President and CEO

General

We are a world leader in primary and refuelable Zinc-Air fuel cell technology, engaging directly and through our subsidiaries in the use of Zinc-Air battery technology for defense and security products and other military applications and for electric vehicles, in car armoring, and in interactive multimedia use-of-force simulators. We have been doing business since February 2003 under the name "Arotech Corporation." We operate in two business units:

- we develop, manufacture and market defense and security products, including advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles; and
- we pioneer advancements in Zinc-Air battery technology for defense and security products and other military applications and for electric vehicles.

Background

We began work in 1990 on the research, development and commercialization of an advanced Zinc-Air battery system for powering electric vehicles, work that continues to this day. Beginning in 1998, we also began to apply our Zinc-Air fuel cell technology to the defense industry, by receiving and performing a series of contracts from the U.S. Army's Communications-Electronics Command (CECOM) to develop and evaluate advanced primary Zinc-Air fuel cell packs. This effort culminated in 2002 in our receipt of a National Stock Number, a Department of Defense catalog number assigned to products authorized for use by the U.S. military, and our subsequent receipt of $2.54 million and $1.6 million delivery orders for our newly designated BA-8180/U military batteries.

We further enhanced our capabilities in the defense industry through our purchase in the third quarter of 2002 of two new subsidiaries: IES Interactive Training, Inc., which provides specialized "use of force" training for police, homeland security personnel and the military, and MDT Protective Industries Ltd., which is engaged in the use of sophisticated lightweight materials and advanced engineering processes to armor vehicles.

Between 1998 and 2002, we were also engaged in the design, development and commercialization of our proprietary Zinc-Air fuel cell technology for portable consumer electronic devices such as cellular telephones, PDAs, digital cameras and camcorders. In October 2002, we discontinued retail sales of our consumer battery products because of the high costs associated with consumer marketing and low volume manufacturing.

We were incorporated in Delaware in 1990, and we have been doing business under the name "Arotech Corporation" since February 2003. We anticipate changing our corporate name to Arotech Corporation at our next annual shareholders' meeting later in 2003. Unless the context requires otherwise, all references to us refer collectively to Electric Fuel Corporation (Arotech) and Arotech's wholly-owned Israeli subsidiary, Electric Fuel (E.F.L.) Limited (EFL), its majority-owned Israeli subsidiary, MDT Protective Industries Ltd., and its wholly-owned Delaware subsidiaries, Electric Fuel Transportation Corp. and IES Interactive Training, Inc.

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

Defense and Security Products

Interactive Use-of-Force Training

Through our wholly-owned subsidiary, IES Interactive Training, Inc. (IES), we provide specialized "use of force" training for police, homeland security personnel and the military. We offer products and services that allow organizations to train their personnel in safe, productive, and realistic environments. We believe that our training systems offer more functionality, greater flexibility, unprecedented realism and a wider variety of user interface options than competing products. Our systems are sold to corporations, government agencies, military and law enforcement professionals around the world. The simulators are currently used by some of the worlds leading training academies, including (in the United States) the Secret Service, the Bureau of Alcohol, Tobacco and Firearms, the Houston Police Department, the Customs Service, the Border Patrol, the Bureau of Engraving and Printing, the Coast Guard, the Federal Law Enforcement Training Centers, the California Department of Corrections, the Detroit

Police Department, the Washington DC Metro Police and international users such as the Israeli Defense Forces, the German National Police, the Royal Thailand Army, the Hong Kong Police, the Russian Security Police, and over 400 other training departments worldwide.

Our interactive training systems range from the powerful Range 3000 use-of-force simulator system to the multi-faceted A2Z Classroom Training system. The Range 3000 line of simulators addresses the entire use of force training continuum in law enforcement, allowing the trainee to use posture, verbalization, soft hand skills, impact weapons, chemical spray, low-light electronic weapons and lethal force in a scenario based classroom environment. The A2Z Classroom Trainer provides the trainer with real time electronic feedback from every student through wireless handheld keypads. The combination of interactivity and instant response assures that learning takes place in less time with higher retention.

Vehicle Armoring

Through our majority-owned MDT Protective Industries Ltd. (MDT), we specialize in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and cars. MDT is a leading supplier to the Israeli military, Israeli special forces and special services. MDT's products are proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide.

Electric Fuel Batteries

We have been engaged in research and development in the field of Zinc-Air electrochemistry and battery design for over ten years, as a result of which we have developed our current technology and its applications. We have successfully applied our technology to our high-energy battery packs for military and security applications. We have also applied our technology to the development of a refuelable Zinc-Air fuel cell for powering zero-emission electric vehicles. Through these efforts, we have sought to position ourselves as a world leader in the application of Zinc-Air technology to innovative primary and refuelable power sources.

We believe that our Zinc-Air batteries provide the highest energy and power density combination available today in the defense market, making them particularly appropriate where long missions are required and low weight is important.

Military Batteries

Our line of existing battery products for the military and defense sectors includes Advanced Zinc-Air Power Packs (AZAPPs) utilizing our most advanced cells (which have specific energy of 400 watt-hours per kilogram), a line of super-lightweight AZAPPs that feature the same 400 Wh/kg cell technology in smaller cells, and our new, high-power Zinc-Air Power Packs (ZAPPs), which offer extended-use portable power using our commercial Zinc-Air cell technology. Our AZAPPs have received a National Stock Number (a Department of Defense catalog number assigned to products authorized for use by the U.S. military), making our AZAPPs available for purchase by all units of the U.S. Armed Forces.

Electric Vehicle

Our Electric Vehicle effort, conducted through our subsidiary Electric Fuel Transportation Corp., continues to focus on obtaining and implementing demonstration projects in the U.S. and Europe, and on building broad industry partnerships that can lead to eventual commercialization of the Zinc-Air energy system. This approach supports our long-term strategy of achieving widespread implementation of the Electric Fuel Zinc-Air energy system for electric vehicles in large commercial and mass transit vehicle fleets. Our all-electric bus, powered by our Zinc-Air fuel cell technology, has demonstrated a world-record 127-mile range under rigorous urban conditions, and we have successfully demonstrated our vehicle in "on-the-road" programs in Germany, Sweden, Italy, Israel and the United States, most recently in public tests in Las Vegas, Nevada in November 2001, and in Washington, D.C., on Capitol Hill, with the participation of certain members of the United States Senate, in March 2002. We intend to strengthen existing relationships and to develop new networks of strategic alliances with fleet operators, companies engaged in energy production and transportation, automobile manufacturers and others in order to establish the infrastructure necessary for further development and commercialization of the Electric Fuel Zinc-Air system.

Lifejacket Lights

We produce water-activated lifejacket lights for commercial aviation and marine applications based on our patented water-activated magne-

sium-cuprous chloride battery technology. We intend to continue to work with OEMs, distributors and end-user companies to expand our market share in the aviation and marine segments. We presently sell four products in the safety products group, two for use with marine life jackets and two for use with aviation life vests. All four products are certified under applicable international marine and aviation safety regulations.

Facilities

Our principal executive offices are located at 632 Broadway, New York, New York 10012, and our telephone number at our executive offices is (646) 654-2107. Our corporate website is www.arotech.com. Our periodic reports to the Securities Exchange Commission, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are available through hyperlinks located on the investor relations page of our website, at http://www.arotech.com/compro/investor.html. 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 our two of our principal subsidiaries, EFL and MDT, are located in Israel (in Beit Shemesh and Lod, respectively, both of which are within Israel's pre-1967 borders). We conduct research and development activities through EFL, and most of our senior management is located at EFL's facilities. We also conduct development and production activities at IES's offices in Littleton, Colorado, and at our new production facility in Auburn, Alabama, which builds and tests advanced batteries for the defense market.

Interactive Use-of-Force Training

We conduct our interactive training activities through our subsidiary IES Interactive Training, Inc. ("IES"), a Delaware corporation based in Littleton, Colorado. IES is a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, homeland security, military and similar applications. With a customer base of over 500 customers in over thirty countries around the world, IES is a leader in the supply of simulation training products to military, law enforcement and corporate client communities. We believe, based on our general knowledge of the size of the interactive use-of-force market, our specific knowledge of the extent of our sales, and discussions we have held with customers at trade shows, etc., that IES provides more than 40% of the worldwide market for government and military judgment training simulators.

Introduction

IES offers consumers the following interactive training products and services:

- *Range 3000* – providing use of force simulation for military and law enforcement. We believe that the Range 3000 is the most technologically advanced judgmental training simulator in the world.
- *A2Z Classroom Trainer* – a state-of-the-art computer based training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom.
- *Summit Training International* – providing relevant, cost-effective professional training services and interactive courseware for law enforcement, corrections and corporate clients.
- *IES Studio Productions* – providing cutting edge multimedia video services for law enforcement, military and security agencies, utilizing the newest equipment to create the training services required by the most demanding authorities.

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

In January 2003, IES was awarded a $2.6 million contract to supply simulation training systems to the largest regional police division in Germany. The contract calls for delivery of several separate interactive training systems, with delivery dates ranging from April to September 2003 and payment dates due following delivery, testing and ascertainment of appropriate run capability of each system.

IES's revenues during 2000, 2001 and 2002 were approximately $3.4 million, $3.5 million and $5.1 million, respectively.

Products

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

Range 3000 "Use of Force" Simulator

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

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

- *Officer's Presence and Demeanor* – Picture-on-picture digital recordings of the trainee's actions allows visual review of the trainee's reaction, body language and weapons handling during the course of the scenario, which then can be played back for debriefing of the trainee's actions.
- *Verbalization* – Correct phrases, timing, manner and sequence of an officer's dialogue is integrated within the platform of the system, allowing the situation to escalate or de-escalate through the officer's own words in the context of the scenario and in conjunction with the trainer.
- *Less-Than-Lethal Training* – Training in the use of non-lethal devices such as Taser, OC (pepper spray), batons and other devices can be used with the video training scenarios with appropriate reactions of each.
- *Soft Hand Tactics* – Low level physical controlled tactics with the use of additional equipment such as take-down dummies can be used.
- *Firearms Training and Basic Marksmanship* – Either utilizing laser based training weapons or in conjunction with a live-fire screen, the use of "Live Ammunition" training can be employed on the system.

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

A2Z Classroom Trainer

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

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

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

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

The individual keypads are connected "wirelessly." The system is completely portable and therefore not location dependent, allowing a complete setup within a matter of minutes.

Key advantages:

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

Summit Training International

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

Conferences

STI has provided conferences throughout the United States, on such topics as:

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

In addition to these national and regional conferences, STI designs and produces training to address specific department issues. STI has a distinguished cadre of instructors that allows adaptation of programs to make them specifically focused for a more intense learning experience. The A2Z Classroom Trainer is incorporated into the "live" presentation creating a stimulating interactive training experience.

Courseware

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

IES Studio Productions

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

Vehicle Armoring

Introduction

MDT Protective Industries Ltd. was established in Israel in 1989 as one of Israel's first car armoring companies, and is Israel's leader in state-of-the art lightweight armoring of vehicles, ranging from light tactical vehicles to passenger vehicles. With two production lines, MDT specializes in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and cars. MDT is a leading supplier to the Israeli military, Israeli special forces and special services. MDT's products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide.

MDT has acquired many years of battlefield experience in Israel. MDT's vehicles have provided proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings. In fact, to our knowledge an MDT-armored vehicle has never experienced bullet penetration into a vehicle cabin under attack. MDT also uses its technology to protect vehicles against vandalism.

MDT's revenues during 2000, 2001 and 2002 were approximately $747,000, $6.5 million and $6.4 million, respectively.

The Armoring Process

Armoring a vehicle involves much more than just adding "armor plates." It includes professional and secure installation of a variety of ar-

mor components – inside doors, dashboards, and all other areas of passenger and engine compartments. MDT uses overlapping sections to ensure protection from all angles, and installs armored glass in the windshield and windows. MDT has developed certain unique features, such as new window operation mechanisms that can raise windows rapidly despite their increased weight, gun ports, run-flat tires, and more. MDT developed the majority of the materials that it uses in-house, or in conjunction with renowned Israeli companies specializing in protective materials.

In order to armor a vehicle, MDT first disassembles the vehicle and removes the interior paneling, passenger seats, doors, windows, etc. MDT then fortifies the entire body of the vehicle, including the roof, motor and other critical components, and reinforces the door hinges. MDT achieves firewall protection from frontal assault with carefully designed overlapping armor. Options, such as air-conditioning, seating modifications and run-flat tires, are also available. MDT fixes the armoring into the shell of the vehicle, ensuring that the installation and finishing is according to the standards set for that particular model. MDT then reassembles the vehicle as close to its original appearance as possible.

Once MDT has ensured full vehicle protection, it places a premium on retaining the original vehicle's look and feel to the extent possible, including enabling full serviceability of the vehicle, thereby rendering the armoring process "invisible." MDT works with its customers to understand their requirements, and together with the customer develops an optimized armoring solution. A flexible design-to-cost process helps evaluate tradeoffs between heavy and light materials and various levels of protection.

By working within the vehicle manufacturer's specifications, MDT maintains stability, handling, center-of-gravity and overall integrity. MDT's methods minimize impact on payload, and retain the full view from the passenger. In most cases all the original warranties provided by the manufacturer are still in effect.

Armoring Materials

MDT offers a variety of armoring materials, optimized to the customer's requirements. MDT uses ballistic steel, composite materials (including Kevlar®, Dyneema® and composite armor steel) as well as special ceramics developed by MDT, together with special armored glass. MDT uses advanced engineering techniques and "light" composite materials, and avoids, to the extent possible, using traditional "heavy" materials such as armored steel because of the added weight, which impairs the driving performance and handling of the vehicle.

All materials used by MDT meet not only all international ballistic standards, but also the far more stringent requirements set down by the Israeli military, the Israeli Ministries of Defense and Transport, and the Israel Standards Institute. MDT's factory has also been granted the ISO 9002 quality standards award.

Products and Services

MDT armors a variety of vehicles for both commercial and military markets. At present, MDT offers armoring for approximately thirty different models of motor vehicles.

In the military market, MDT armors:

- troop and personnel carriers (such as vehicles in the Mercedes-Benz Vario and Sprinter lines)
- front-line police and military vehicles (such as the Mitsubishi Storm 4×4)
- command vehicles (such as the Land Rover Defender 4×4)
- specialty vehicles (such as HumVees).

In the commercial market, MDT armors:

- passenger vans and sports utility vehicles (such as the Chevrolet Savana, the General Motors Vandura and the Ford Econoline)
- money and valuables carriers (such as the Volkswagen T4 Transporter)
- luxury sedans (including a variety of models made by Mercedes, Cadillac, Volvo, Lincoln, etc.)
- ambulances (such as those made by Chevrolet).

Electric Fuel Batteries for Defense and Homeland Security

We base our strategy in the field of military batteries on the development and commercialization of our next-generation Zinc-Air fuel cell technology, as applied in our batteries that we produce for the U.S. Army's Communications and Electronics Command (CECOM). 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.

Since 1998 we have received and performed a series of contracts from the U.S. Army's Communications-Electronics Command (CECOM) to develop and evaluate advanced primary Zinc-Air fuel cell packs. The terms of the current extension of a contract initially issued in 2001 call for us to deliver 500 prototype battery packs, and procure and install certain production equipment. The 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, weighs only about five pounds and has approximately twice the energy capacity per pound of the U.S. Army's standard lithium-sulfur dioxide battery packs.

In the second half of 2002, our five-year program with the US Army's Communications Electronics Command (CECOM) to develop a Zinc-Air battery for battlefield power culminated in the assignment of a National Stock Number and a $2.54 million delivery order for the newly designated BA-8180/U battery.

The BA-8180/U battery is our first defense battery product to go into mass production. We are developing other military batteries and related products that we hope to get into production in 2003 and 2004.

Advanced Zinc-Air Power Pack (AZAPPs)

BA-8180/U

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

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

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

During the second half of 2002, CECOM assigned a National Stock Number (NSN) to our Zinc-Air battery, making it possible to order and stock the battery for use by the Armed Forces. During the fourth quarter, CECOM assigned the designation BA-8180/U to our Zinc-Air battery, the first time an official US Army battery designation was ever assigned to a Zinc-Air battery.

Also during the fourth quarter of 2002, CECOM provided us with a $2.54 million letter contract for delivery of BA-8180/U batteries and associated electrical interface adapters. The contract calls for order releases during the first three calendar quarters of 2003, with a current order ceiling of $2,543,250. Under the terms of the letter contract, a formal contract is to be entered into during the first quarter of 2003.

In April 2003, we announced that we had received an additional $1.6 million order from CECOM for a delivery order of advanced Zinc-Air batteries, with deliveries anticipated to take placed from September through November 2003.

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

Other AZAPP Products

The BA-8180/U was the first battery approved for military use based on our 30Ah Zinc-Air cell. We have also developed, with partial funding from CECOM, a 12-cell, 12 volt battery using the same 30Ah Zinc-Air cell. This battery, called the AZAPP FB, is currently in limited production for field testing purposes.

We are also working on two additional cell sizes. The first of these, a 20Ah cell, was developed for the Army's Land Warrior program, and some battery prototypes incorporating these cells have already been delivered to the Army under the terms of a Land Warrior subcontract that we received and completed in 2002.

We have also completed the conceptual design of a 40Ah cell and a 24-cell battery pack incorporating such a cell. We hope to complete the design of this cell in 2003 and put it into production either in late 2003 or early 2004.

Ancillary products

In order to provide compatibility between the BA-8180/U and various items of military equipment, we will supply three types of electrical interface adapters for the BA-8180/U, including equipment-specific adapters for the AN/PRC-119 SINCGARS and SINCGARS ASIP tactical radio sets, and a generic interface for items of equipment that were designed to interface with a BA-5590 or equivalent battery. Each of the three interfaces was also assigned a national stock number (NSN) by CECOM. We will continue to develop interface adapters that for our batteries as the need arises.

We have also developed interface adapters for other items of equipment which require higher power than the BA-8180/U can provide by itself. For example, we have developed a hybrid battery system comprising a BA-8180/U battery pack and two small rechargeable lead-acid packs. Even with the weight of the lead-acid batteries, this hybrid system powers a satellite communications terminal for significantly longer than an equivalent weight of BA-5590 $LiSO_2$ battery packs. We have also developed experimental hybrid systems incorporating other rechargeable technologies, such as lithium-ion batteries and ultracapacitors.

UAV/MAV

We are currently under contract with the U.S. military and an Israeli security agency, to demonstrate the feasibility of Zinc-Air batteries for both unmanned aerial vehicles (UAV) and micro-air vehicles (MAV) platforms, respectively.

Short-term development goals include the optimization and integration of cell components for performance and manufacturability. System-level objectives include refinement of battery envelope design and vehicle interfaces, and actual flight testing. We anticipate that the first fieldable batteries can be ready in 2004.

UAVs

Man-portable UAVs are considered to be an increasingly important battlefield tool for reconnaissance and surveillance of enemy positions. At present, power sources available to the military provide only marginally adequate operating times for these UAVs. For example, the Marine Corps' DragonEye system, operating off primary lithium batteries, can run for 30 to 60 minutes. We expect to achieve a cruise time of at least two hours using an equivalent weight of Zinc-Air cells.

MAVs

Development of electrically propelled MAVs has been hampered by the lack of a satisfactory battery solution. Achievement of our development targets will enable a Zinc-Air battery to power a typical 5-oz. MAV for as long as 30 minutes.

Zinc-Air Power Packs (ZAPPs)

During 2002 we developed a family of 12V batteries built around our high-power 4Ah metal cell. These batteries are aimed at the Homeland Security market and are designed to provide back-up power for portable 12V equipment such as handheld chemical or biological sensors. The first battery in this family to become ready for production is the ZAPP-48, which is a 14Ah battery capable of working at a continuous current of 2.5A.

Technology

All batteries convert chemical energy to electrical energy through two separate electrochemical reactions: one consuming electrons (at the cathode) and the other releasing them (at the anode). These half-cell reactions are physically separated within the battery, allowing ions to flow between them, but not electrons. It is this separation that allows a battery to produce electrical power: The electrons are made to do work on their journey to the other side of the battery by passing across an electrical load, such as a light bulb, motor, or other electrically powered component or device.

Our Zinc-Air battery's superiority over other battery technologies lies in the underlying electrochemical make-up of a Zinc-Air cell. While other battery cells must carry the cathodic reagent – the active material that "consumes" the electrons freed at the anode – within the weight and volume of the battery, a Zinc-Air cell consumes oxygen that it extracts from the atmosphere.

On the anode side, the reaction in the Zinc-Air cell is the same as that of the common alkaline battery, wherein zinc, the active anodic material, is converted to zinc-oxide by reaction with hydroxyl ions present in the electrolyte.

On the cathode side, the reaction in both the Zinc-Air and alkaline batteries involves the reduction of oxygen to create those hydroxyl ions. In the case of the alkaline battery, an oxidizing material (manganese dioxide) is deployed inside the cell to provide the oxygen. The Zinc-Air cell, on the other hand, employs an air-permeable, hydrophobic, catalytic membrane which extracts oxygen from the atmosphere.

Thus, Zinc-Air has a weight and volume advantage over most other battery technologies, because one of its two active reagents, *i.e.*, oxygen, adds no weight or volume within the cell. This frees up a lot of space inside the cell, which means that the zinc anode, our cell's energy storehouse, makes up most of the cell's weight and volume.

In addition to outstanding performance, Zinc-Air technology boasts two additional features that make it extremely attractive for military and security use:

- Safety: A Zinc-Air battery is an inherently safe battery, in storage, transportation, use, and disposal. The danger of fire, explosion or personnel exposure to hazardous materials is lower than in any other battery technology.
- Environment-friendliness: Zinc-Air cells contain no added mercury or other hazardous elements such as lead or cadmium that are often used in batteries, and in fact Zinc-Air batteries can be disposed of with household trash.

Electric Vehicles

Introduction

We believe that environmental concerns and current and proposed legislation create incentives for fleet operators to use zero emission electric vehicles, and that the Electric Fuel Zinc-Air Energy System for electric vehicles is particularly suitable for use by such fleet operations. We believe the U.S. government will continue to use us as a subcontractor to develop electric vehicles, and we hope this support will create incentives for fleet operators (primarily bus and mass transit operators) to introduce electric vehicles into their fleets. We further believe that recent government interest in hydrogen fuel cells is to our benefit, since we believe that an examination of the advantages and disadvantages offered by both hydrogen fuel cells and the Electric Fuel Zinc-Air Energy System for electric vehicles demonstrates that our system offers a mature technology that is technology that is ready to be implemented in a short time frame, unlike hydrogen fuel cells, which we believe are decades away from being a practical and economic alternative to traditional petroleum-based fuel sources. Moreover, a recent study that we commissioned from consulting firm Arthur D. Little projected significant life cycle cost benefits for Zinc-Air when compared with hydrogen fuel cell technology over a five to ten year period.

The Electric Fuel Zinc-Air Energy System for Electric Vehicles

The Electric Fuel Zinc-Air Energy System consists of:

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

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

We believe that our Zinc-Air fuel cell system for powering electric vehicles offers numerous advantages over other electric vehicle batteries that make it ideal for fleet and mass transit operators. Fleet operators require a long operating range, large payload capacity, operating flexibility, all-weather performance, fast vehicle turn-around and competitive life-cycle costs. Electric Fuel-powered full-size vehicles, capable of long-range, high-speed travel, could fulfill the needs of transit operators in all weather conditions, with fast, cost-effective refueling. An all-electric, full-size bus powered by the Electric Fuel system can provide to transit authorities a full day's operating range for both heavy duty city and suburban routes in all weather conditions.

In field trials with major European entities, we have demonstrated the commercial viability of our battery system by regularly driving 300 to 400 km in actual drive cycles. In 1996, a Mercedes-Benz MB410 van powered by our Zinc-Air fuel cell crossed the Alps, traveled from Chambray, France over the Moncenisio Pass, and continued to the Zinc-Air regeneration plant operated by Electric Fuel's Italian licensee, Edison Termoelettrica, SpA, in Turin, Italy. The 152 mile (244 km) drive included a 93 mile (150 km) continuous climb over mountainous terrain in which the vehicle climbed over 4,950 feet (1,500 meters) to reach the summit at 6,874 feet (2,083 meters), using only 65% of the battery's capacity. In November 1997, an electric Mercedes-Benz MB410 van drove from central London to Central Paris on a single charge – a distance of 272 miles (439 km), not including the rail transport through the English Channel Tunnel.

During 2002, we successfully completed Phase II of our program with the U.S. Department of Transportation's Federal Transit Administration. Among the items successfully tested during Phase II were ultracapacitors designed to improve and increase the performance of our bus. During this performance testing, our bus was driven a record-breaking 127 miles, more than 100 of them under the rigorous stop-and-go diving conditions of the Society of Automotive Engineers' Central Business District (CBD) cycle with a full passenger load. We demonstrated our bus in a public demonstration in Las Vegas, Nevada in November 2001, and in Washington, D.C., on Capitol Hill, with the participation of certain members of the United States Senate, in March 2002. In October 2002, we received approval from the FTA to subcontract at least half of the $2 million budget associated with the new Phase III of our Electric Transit Bus Program (described below), with remainder of the budget shared by the partners in the program.

Major Programs

We have formed several strategic partnerships and are engaged in demonstration programs involving the Electric Fuel Zinc-Air Energy System for electric vehicles in various locations in the U.S. and Europe.

The Department of Transportation-Federal Transit Administration Zinc-Air All Electric Transit Bus Program

In the United States, our Zinc-Air technology is the focus of a Zinc-Air All Electric Bus demonstration program the costs and expenditures of which are 50% offset by subcontracting fees paid by the U.S. Department of Transportation's Federal Transit Administration. Phase I of the project, which was for $4 million, was completed in July 2000. Phase II of the project, which was for $2.7 million, was completed in July 2002, and subcontracting for Phase III was approved in October 2002.

The program provides that the bus will utilize the new all-electric, battery/battery/ultracapacitor-hybrid propulsion system that we are jointly developing with General Electric's research and development center, with funding from the Israeli-U.S. Bi-National Industrial Research and Development (BIRD) Foundation (described below). The bus used in the program is a standard 40-foot (12.2 meter) transit bus manufactured by NovaBus Corporation. It has a capacity of 40 seated and 37 standing passengers and a gross vehicle weight of 39,500 lbs. (17,955 kg.). The all-electric hybrid system consists of an Electric Fuel Zinc-Air fuel cell as the primary energy source, an auxiliary battery to provide supplementary power and recuperation of energy when braking. Ultracapacitors enhance this supplementary power, providing faster throughput and higher current in both directions than the auxiliary battery can supply on its own. The vehicle draws cruising energy from the Zinc-Air fuel cell, and supplementary power for acceleration, merging into traffic and hill climbing, from the auxiliary battery and ultracapacitors.

The program, which includes General Electric and the Regional Transportation Commission of Southern Nevada (RTC) as project partners, seeks to demonstrate the ability of the Electric Fuel battery system to power a full-size, all-electric transit bus, providing a full day's range for heavy duty city and suburban routes, under all weather conditions. In November 1998, a consortium consisting of Electric Fuel, the Center for Sustainable Technology, L.L.C. and RTC received approval for $2 million in federal subcontracting fees for the $4 million Zinc-Air Electric Transit Bus Program (Phase I). Additional project partners included the Community College of Southern Nevada and the Desert Research Institute. We successfully completed this phase in July 2000.

Phase II focused on conducting evaluation of the system and vehicle performance, including track testing and limited on-road demonstrations, and enhancing the all-electric propulsion system developed in Phase I. Phase II also in-

cluded testing and comparing the incorporation of ultracapacitors and associated interface controls in the Zinc-Air fuel cell system. Phase II was completed in July 2002, after successfully meeting all the original performance designed requirements (as per the American Public Transport Association's standard for transit buses) without addition of the ultracapacitors, and exceeding them in tests with the introduction of ultracapacitors.

The new Phase III effort, which was announced in October 2002, focuses on installation, testing and commissioning of new generation advanced ultracapacitors and associated interface controls. Advanced techniques will be used to implement control of the bus auxiliaries to optimize their efficiency and minimize energy consumption. The entire system will be analyzed, assessed and compared to previous configurations. Further evaluations of the system and vehicle performance, including track testing and limited on-road demonstrations, will also be carried out.

We are the principal participant in Phase III, with overall technical and administrative responsibility. The responsibilities of General Electric relate to the auxiliary control system and the ultracapacitor configuration. The Regional Transportation Commission of Southern Nevada, which was also a project participant in Phase II, continues its role in leading the project's peer review committee.

A performance evaluation test is anticipated to take place in Rome, New York in late 2003, where improvements over the previous configurations, if any, will be measured.

We believe that electric buses represent a particularly important market for electric vehicles in the United States. Transit buses powered by diesel engines operate in large urban areas where congestion is a fact of life and traffic is largely stop-and-go. As a result, they are the leading contributor to inner city toxic emissions, and are a major factor for those U.S. cities that have been designated as in "non-attainment" with respect to air quality standards. Moreover, the U.S. Environmental Protection Agency has identified particulate emissions from diesel engine emissions as a carcinogen.

Our Zinc-Air energy system is particularly suitable for transit buses because transit buses must operate for up to 12 hours a day on a single battery charge. Furthermore, transit buses require a large energy storage battery to power the vehicle while attending to passenger needs such as air-conditioning and handicapped access. The test program is designed to prove that an all-electric bus can meet these and all other Los Angeles and New York Municipal Transit Authority mass transit requirements including requirements relating to performance, speed, acceleration and hill climbing.

All-Electric Hybrid Propulsion System for Transit Buses and Heavy Duty Vehicles – the BIRD Program

We and General Electric are also jointly developing an all-electric, battery/battery-hybrid propulsion system for powering electric buses and heavy-duty trucks. In July 1998 the BIRD Foundation awarded the two companies funding for the joint development of the electric propulsion system. The first application for the system will be an all-electric, zero-emission, full-size transit bus, in the program subcontracted to us by the Federal Transit Administration of the U.S. Department of Transportation referred to above. Our portion of the project related to a mobile refueling system for the transit bus. The refueling system, build in two standard 40" containers, was commissioned and successfully demonstrated in the All Electric Bus project. General Electric's portion of the project was to develop the EMS Energy Management System, which manages and controls all the various energy suppliers and consumers of the bus. The EMS was tested successfully as part of the integration drives completed under phase I of the FTA project.

Germany - Consortium Project

In January 2000, we agreed to participate in a new cooperative, all-electric hybrid vehicle development and demonstration program in Germany. A consortium consisting of major German industrial firms such as DaimlerChrysler AG, EPCOS and Varta Batterie AG will implement the program. The German Post, which sponsored an extensive field test of our Zinc-Air fuel cell system for electric vehicles from 1995 through 1998, has also joined the consortium as an Advisory Partner. In January 2001, we received a DM 1 million ($469,000) order for Zinc-Air fuel-cells and zinc anodes that we delivered during 2001, and we completed this project with a successful on-road demonstration of our Zinc-Air van in December 2002.

Lifejacket Lights

In 1996, we began to produce and market lifejacket lights built with our patented magne-

sium-cuprous chloride batteries, which are activated by immersion in water (water-activated batteries), for the aviation and marine safety and emergency markets. At present we have a product line consisting of four lifejacket light models, 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 in our factory in Beit Shemesh, Israel.

Backlog

We generally sell our products under standard purchase orders. Orders constituting our backlog are subject to changes in delivery schedules and are typically cancelable by our customers until a specified time prior to the scheduled delivery date. Accordingly, our backlog is not necessarily an accurate indication of future sales. As of December 31, 2001 and 2002, our backlog for the following year was approximately $1.0 million and $7.2 million, respectively, divided among our product lines as follows:

Product Line	2001	2002
Electric vehicle	$ 381,000	$ 420,000
Water-activated batteries	–	300,000
Security and defense batteries	300,000	2,700,000
Car armoring	–	1,040,000
Interactive use-of-force training	–	2,690,000
Other	–	–
TOTAL:	$ 681,000	$7,150,000

Price Range of Common Stock

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

Year Ended December 31, 2002	High	Low
Fourth Quarter	$ 1.06	$ 0.61
Third Quarter	$ 1.59	$ 0.83
Second Quarter	$ 1.68	$ 0.73
First Quarter	$ 2.20	$ 1.42
Year Ended December 31, 2001		
Fourth Quarter	$ 2.43	$ 1.30
Third Quarter	$ 2.75	$ 1.30
Second Quarter	$ 3.95	$ 2.30
First Quarter	$ 8.00	$ 3.50

As of February 28, 2003 we had approximately 300 holders of record of our common stock.

Dividends

We have never paid any cash dividends on our common stock. The Board of Directors presently intends to retain all earnings for use in our business. Any future determination as to payment of dividends will depend upon our financial condition and results of operations and such other factors as the Board of Directors deems relevant.

Five-Year Summary of Selected Financial Data

The selected financial information set forth below with respect to the consolidated financial statements for each of the four fiscal years in the period ended December 31, 2002, and with respect to the balance sheets at the end of each such fiscal year has been derived from our consolidated financial statements audited by Kost Forer & Gabbay, independent certified public accountants in Israel and a member firm of Ernst & Young Global.

The results of operations, including revenue, operating expenses, and financial income of the consumer battery segment for the years ended December 31, 2002, 2001, 2000, 1999 and 1998 have been reclassified in the accompanying statements of operations as discontinued operations. Our balance sheets at December 31, 2002, 2001, 2000, 1999 and 1998 give effect the assets of the consumer battery business as discontinued operations within current assets and liabilities. Thus, the financial information presented herein includes only continuing operations.

The selected financial information set forth below with respect to the consolidated financial statements for the fiscal year ended December 31, 1998 and with respect to the balance sheet at the end of such fiscal year has been derived from our financial statements audited by Kesselman & Kesselman, independent certified public accountants in Israel and a member firm of PriceWaterhouseCoopers International Limited.

The financial information set forth below is qualified by and should be read in conjunction with the Consolidated Financial Statements contained in this Annual Report.

	Year Ended December 31,				
	1998	1999	2000	2001	2002
	(dollars in thousands, except per share data)				
Statement of Operations Data:					
Revenues	$ 4,013	$ 2,422	$ 1,490	$ 2,094	$ 6,407
Research and development expenses and costs of revenues	6,622	3,867	1,985	2,448	5,108
Selling, general and administrative expenses and amortization of intangible assets	3,561	2,754	3,434	3,934	5,982
Operating (loss)	(6,210)	(4,198)	(3,929)	(4,288)	(4,683)
Financial income, net	652	190	544	263	100
Loss before taxes on income	(5,558)	(4,008)	(3,385)	(4,026)	(4,583)
Taxes on income	(43)	6	–	–	–
Net loss before minority interest in profit of subsidiary	(5,515)	(4,014)	(3,385)	(4,026)	(4,583)
Minority interest in profit of subsidiary	–	–	–	–	(355)
Net loss from continuing operations	(5,515)	(4,014)	(3,385)	(4,026)	(4,938)
Net loss from discontinued operations	(3,018)	(2,902)	(8,596)	(13,261)	(13,566)
Net loss for the period	(8,533)	(6,916)	(11,981)	(17,287)	(18,504)
Deemed dividend to certain shareholders of common stock	–	–	–	(1,197)	–
Net loss attributable to shareholders of common stock	$ (8,533)	$ (6,916)	$ (11,981)	$ (18,483)	$ (18,504)
Net loss per share for combined operations	$ (0.6	$ (0.4	$ (0.6	$ (0.7	$ (0.57)
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands)	14,013	14,334	19,243	24,200	32,382

	As At December 31,				
	1998	1999	2000	2001	2002
Balance Sheet Data:					
Cash, cash equivalents, investments in marketable debt securities and restricted collateral deposits	$ 8,943	$ 2,556	$ 11,596	$ 12,672	$ 2,091
Receivables and other assets*	4,300	5,215	13,771	11,515	7,895
Property and equipment, net of depreciation	2,156	2,258	2,289	2,221	2,555
Goodwill and other intangible assets, net	–	–	–	–	7,522
Total assets	$ 15,399	$ 10,029	$ 27,656	$ 26,408	$ 20,063
Liabilities*	$ 4,818	$ 5,787	$ 7,578	$ 7,000	$ 11,025
Stockholders' equity	10,581	4,242	20,078	19,408	9,038
Total liabilities and stockholders equity*	$ 15,399	$ 10,029	$ 27,656	$ 26,408	$ 20,063

* Includes assets and liabilities from discontinued operations.

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements contained in Item 8 of this report, and the notes thereto. We have rounded amounts reported here to the nearest thousand, unless such amounts are more than 1.0 million, in which event we have rounded such amounts to the nearest hundred thousand.

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, and impairment of intangible assets. 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, among others, affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition and Bad Debt

We generate revenues primarily from sales of multimedia and interactive digital training systems and use-of-force simulators specifically targeted for law enforcement and firearms training and from service contracts related to such sales, from providing lightweight armoring services of vehicles, and, to a lesser extent, from sale of zinc-air battery products for defense applications and from development services and long-term arrangements subcontracted by the U.S government. We recognize revenues in respect of products when, among other things, we have delivered the goods being purchased and we believe collectibility to be reasonably assured. We do not grant a right of return to our customers. We perform ongoing credit evaluations of our customers' financial condition and we require collateral as deemed necessary. An allowance for doubtful accounts is determined with respect to those accounts that we have determined to be doubtful of collection. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required, and this might cause a revision of recognized revenues.

Revenues from development services are recognized using contract accounting on a percentage of completion method, based on completion of agreed-upon milestones and in accordance with the "Output Method" or based on the time and material basis. Provisions for estimated losses on uncompleted contracts are recognized in the period in which the likelihood of such losses is determined.

Inventories

We state our inventories 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. Our reserves for excess and obsolete inventory are primarily based upon forecasted demand for our products, and any change to the reserves arising from forecast revisions would be reflected in cost of sales in the period the revision is made.

Goodwill

Goodwill represents the excess of cost over the fair value of the net assets of businesses acquired.

As required by applicable accounting rules, we test goodwill for impairment at least annually and between annual tests in certain circumstances, and we write down goodwill when impaired, rather than amortizing it as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value with its carrying value. Fair value is determined using discounted cash flows, market multiples and market capitalization. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units.

The determination of the value of goodwill requires management to make assumptions regarding estimated 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 impairment charges. Any material change in our valuation of assets in the future and any consequent adjustment for impairment could have a material adverse impact on our future reported financial results.

As a result of MDT and IES acquisitions, we recorded goodwill in the amount of $4,954,981 as of December 31, 2002.

Impairment of long-lived assets and intangibles

Long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" 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 an asset 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. As of December 31, 2002, no impairment losses have been identified.

The determination of the value of such long-lived and intangible assets requires management to make assumptions regarding estimated 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 impairment charges. Any material change in our valuation of assets in the future and any consequent adjustment for impairment could have a material adverse impact on our future reported financial results.

As a result of MDT and IES acquisitions, we recorded intangible assets in the amount of $2.6 million as of December 31, 2002.

Business Combinations

We have accounted for the combination with IES and MDT utilizing the purchase method of accounting. The combination required management to estimate the fair value of the assets acquired and liabilities assumed. These estimates have been based on our business plans for the entity acquired. Should the actual use of assets or resolution of obligations differ from our estimates, revisions to the estimated fair values would be required. If a change in estimate occurs after one year following the acquisition, the change would be recorded in our statement of operations.

Recent Accounting Pronouncements

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses significant issues regarding the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. We do not expect the adoption of SFAS No. 146 to have a material impact on our results of operations or financial position.

Recent Developments

German Police Order

In January 2003, IES was awarded a $2.6 million contract to supply simulation training systems to the largest regional police division in Germany. The contract calls for delivery of several separate interactive training systems, with delivery dates ranging from April to September 2003 and payment dates due following delivery, testing and ascertainment of appropriate run capability of each system.

CECOM Orders

In December 2002, we entered into a contract with the US Army Communications Electronic Command (CECOM) pursuant to 10 U.S.C. § 2304c(2), "Unusual and Compelling Urgency," for a delivery order of advanced Zinc-Air batteries. The contract calls for order releases during the first three calendar quarters of 2003, with a current order ceiling of $2,543,250.

In April 2003, we announced that we had received an additional $1.6 million order from CECOM for a delivery order of advanced Zinc-Air

batteries, with deliveries anticipated to take placed from September through November 2003.

General

During 2002, we acquired two new subsidiaries, IES and MDT, we closed our money-losing consumer battery operations, and we re-organized into two divisions: Defense and Security Products and Electric Fuel Batteries. We have previously been organized into Instant Power, Electric Vehicles, and Defense and Security Products. Additionally, we focused on increasing our activities in the defense and security sectors, following the expansion of our battery development and procurement contracts with the US Army's Communications Electronics Command (CECOM) and other defense-related agencies, while searching for new opportunities to market our core Zinc-Air technology for commercial applications and to OEMs. With an expanded focus on defense and homeland security technology and business opportunities, we launched new Zinc-Air battery products designed to meet the requirements of this market. We also concentrated intensive efforts on various cost-cutting strategies, including downsizing staff in areas showing lower productivity and mandating participation among salaried employees in our options-for-salary plan, whereby employees permanently waived a portion of their salaries (generally between 15% and 25%) in exchange for options to purchase shares of our common stock at a ratio of options to purchase 2.5 shares of our stock for each dollar in salary waived. These options are issued at a market value exercise price, so that they are not recorded as an expense on our financials. This program ended at the end of 2002.

In conjunction with these cost-cutting efforts and with the movement of our activities away from consumer sales and in the direction of defense and security products and services, we decided during the third quarter of 2002 to discontinue retail sales of our consumer battery products, effective in October 2002. As a result of this decision, more than 60 employees were terminated. The discontinuation of the consumer retail products resulted in a one-time, pre-tax charge of approximately $7.1 million during 2002, reflecting a write-down of inventory and net fixed assets as well as costs associated with the reduction in our workforce. Almost all these charges were non-cash impacting items.

Our line of existing battery products for the military and defense sectors includes 12/24V, 30/60Ah Advanced Zinc-Air Power Packs (AZAPPs) utilizing our most advanced cells (which have specific energy of 400 Wh/kg), a line of super-lightweight AZAPPs that feature the same 400 Wh/kg cell technology in new 16Ah cells, and our new, high-power 12V Zinc-Air Power Packs (ZAPPs), which offer extended-use 12V portable power and current ratings up to 3.5A, using our commercial Zinc-Air cell technology.

Our Electric Fuel Batteries Division is continuing with the production of Zinc-Air fuel cell packs for the U.S. Army's Communications Electronics Command (CECOM). The 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, is approximately the size and weight of a notebook computer. The battery is based on a new generation of lightweight, 30 ampere-hours cells developed by us for both military and future commercial products with high energy requirements.

In December 2002, we entered into a contract with the US Army Communications Electronic Command (CECOM) pursuant to 10 U.S.C. § 2304c(2), "Unusual and Compelling Urgency," for a delivery order of advanced Zinc-Air batteries.

The contract calls for order releases during the first three calendar quarters of 2003, with a current order ceiling of $2,543,250.

Under the terms of the contract, we will produce and supply the BA-8180/U Zinc-Air Nonrechargeable Battery. BA-8180/U is the new Army designation for Electric Fuel's Model FC Advanced Zinc-Air Power Pack, as it was previously known during its development phase. In addition, we will supply three types of electrical interface adapters for the BA-8180/U, including equipment-specific adapters for the AN/PRC-119 SINCGARS and SINCGARS ASIP tactical radio sets, and a generic interface for items of equipment that were designed to interface with a BA-5590 or equivalent battery. Each of the three interfaces was also assigned a national stock number (NSN) by CECOM. The BA-8180/U was assigned an NSN in August 2002.

The BA-8180/U is a 12/24 volt, 800 watt-hour battery pack approximately the size and weight of a notebook computer. The battery is based on a new generation of lightweight, 30

ampere-hours cells that we developed over the last five years with partial funding by CECOM. In extensive field testing, the BA-8180/U battery typically provided 4 to 6 times the run time of a BA-5590, a primary lithium battery pack widely used in the military.

Additionally, the Electric Fuel Batteries Division is continuing with the introduction of the new emergency lights for the marine life jackets market.

In July 2002, our existing research and development contract with CECOM was modified to provide us with additional funding of ten thousand dollars in order to develop prototype zinc air batteries for battlefield drones. As a result, we developed and plan to produce advanced zinc-air batteries for unmanned air vehicles (UAVs) and micro air vehicles (MAVs). The new batteries will provide the military's man-portable battlefield drones with longer range and flying time than existing battery alternatives. Our solutions for UAVs and MAVs are high-power, lightweight versions of our most advanced zinc-air cells, which have specific energy of 400 Wh/kg.

Our Electric Fuel Batteries Division is also continuing its American all-electric transit bus demonstration project, subcontracted by the Federal Transit Administration (FTA). We successfully completed Phase I in June 2000 and Phase II of the FTA program in July 2002, and have recently received approval of subcontracting fees from the FTA to begin Phase III of the program, which will focus on an evaluation of the performance of Zinc-Air battery propulsion systems for transit buses; the installation of new advanced ultra capacitors; and the implementation of an advanced control system for auxiliaries.

During 2002, we continued to invest in strengthening our intellectual property position. We have 42 unexpired U.S. patents and 15 corresponding European patents issued covering general aspects and various applications of our Zinc-Air technology; these patents expire between 2007 and 2018.

We have experienced significant fluctuations in the sources and amounts of our revenues and expenses, and we believe that the following comparisons of results of operations for the periods presented do not necessarily provide a meaningful indication of our development. Our research and development expenses have been offset, to a limited extent, by the periodic receipt of research grants from Israel's Office of the Chief Scientist. We expect that, because of these and other factors, including our acquisitions of IES and MDT, our discontinuation of certain of our operations, and general economic conditions and delays due to legislation and regulatory and other processes and the development of competing technologies, future results of operations may not necessarily be meaningfully compared with those of current and prior periods. Thus, we believe that period-to-period comparisons of its past results of operations should not necessarily be relied upon as indications of future performance.

We incurred significant operating losses for the years ended December 31, 2000, 2001 and 2002. While we expect to continue to derive revenues from the sale of defense and security products that we manufacture (directly and through our subsidiaries) and from components of the Electric Fuel Electric Vehicle System, there can be no assurance that we will ever derive such revenues or achieve profitability.

Functional Currency

We consider the United States dollar to be the currency of the primary economic environment in which we and our Israeli subsidiary Electric Fuel (E.F.L) Ltd. ("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 MDT is in New Israel Shekels ("NIS") and a substantial portion of MDT's costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT. Accordingly, the financial statements of MDT have been translated into U.S. dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts has been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive loss in shareholders' equity.

Results of Operations

Preliminary Note

Results for the year ended December 31, 2002 include the results of IES and MDT for such period as a result of our acquisitions of

these companies early in the third quarter of 2002. The results of IES and MDT were not included in our operating results for the year ended December 31, 2001. Accordingly, the following year-to-year comparisons should not necessarily be relied upon as indications of future performance.

In addition, results are net of the operations of the retail consumer battery products, which operations were discontinued in the third quarter of 2002.

Fiscal Year 2002 compared to Fiscal Year 2001

Revenues**.** Revenues from continuing operations for the year ended December 31, 2002 totaled $6.4 million, compared to $2.1 million for 2001, an increase of $4.3 million, or 206%. This increase was primarily the result of the inclusion of IES and MDT in our results in 2002.

During 2002, we recognized revenues from the sale of interactive use-of-force training systems (through our IES subsidiary), from payments under vehicle armoring contracts (through our MDT subsidiary), and from the sale of lifejacket lights, as well as under contracts with the U.S. Army's CECOM for deliveries of batteries and for design and procurement of production tooling and equipment. We also recognized revenues from subcontracting fees received in connection with Phase II of the United States Department of Transportation (DOT) program, which began in the fourth quarter of 2001 and was completed in July 2002, and Phase III of the DOT program, which began in October 2002. We participate in this program as a member of a consortium seeking to demonstrate the ability of the Electric Fuel battery system to power a full-size, all-electric transit bus. The total program cost of Phase II was $2.7 million, 50% of which was covered by the DOT subcontracting fees. Subcontracting fees cover less than all of the expenses and expenditures associated with our participation in the program. In 2001, we derived revenues principally from the sale of lifejacket lights, under contracts with the U.S. Army's CECOM for deliveries of batteries and for design and procurement of production tooling and equipment and from subcontracting fees received in connection with the DOT program.

In 2002, revenues were $4.7 million for the Defense and Security Products Division (compared to $0 in 2001)**,** due to the inclusion of IES and MDT in our 2002 results, and $1.7 million for the Electric Fuel Batteries Division (compared to $2.1 million in the comparable period in 2001**,** a decrease of $411,000, or 20%), due primarily to $471,000 in revenues from a German consortium project relating to our electric vehicle that were included in 2001 but that did not exist in 2002. Of the $4.7 million increase in Defense and Security Products revenues, $2.0 million was attributable to the inclusion of IES in our results in 2002 and $2.7 million was attributable to the inclusion of MDT in our results in 2002.

Cost of revenues and gross profit. Cost of revenues totaled $4.4 million during 2002, compared to $2.0 million in 2001**,** an increase of $2.4 million, or 122%**,** due to the inclusion of IES and MDT in our 2002 results.

Direct expenses for our two divisions during 2002 were $4.4 million for the Defense and Security Products Division (compared to $0 in 2001)**,** due to the inclusion of IES and MDT in our 2002 results, and $3.1 million for the Electric Fuel Batteries Division (compared to $2.3 million in the comparable period in 2001**,** an increase of $767,000, or 33%), due primarily to the following factors:

- We began to ramp up production at our CECOM facility in Alabama in anticipation of the CECOM order that we received in December 2002; and
- We wrote off certain disqualified CECOM inventory in the amount of $116,000.

Of the $4.4 million increase in Defense and Security Products direct expenses, $2.1 million was attributable to the inclusion of IES in our results in 2002 and $2.3 million was attributable to the inclusion of MDT in our results in 2002.

Gross profit was $2.0 million during 2002, compared to $101,000 during 2001, an increase of $1.9 million. This increase was the direct result of all factors presented above, most notably the inclusion of IES and MDT in our 2002 results. In 2002, IES contributed $1.3 million to our gross profit, and MDT contributed $1.1 million, which was offset by a gross loss of $360,000 in our other divisions.

Research and development expenses**.** Research and development expenses for 2002 were $686,000, compared to $456,000 in 2001, an increase of $230,000, or 50%. This increase was primarily the result of the inclusion of IES, which accounted for $130,000 of the increase, in our 2002 results.

Sales and marketing expenses**.** Sales and marketing expenses for 2002 were $1.3 million,

compared to $106,000 in 2001, an increase of $1.2 million, or 1,136%. This increase was primarily attributable to the following factors:

- We had sales and marketing expenses in 2002 related to IES of $572,000, which we did not have in 2001;
- We had sales and marketing expenses in 2002 related to MDT of $63,000, which we did not have in 2001; and
- We incurred expenses for consultants, primarily lobbyists, in the amount of $128,000 in connection with our Electric Vehicle program and $441,000 in connection with our CECOM battery program with the U.S. Army.

***General and administrative expenses*.** General and administrative expenses for 2002 were $4.0 million compared to $3.8 million in 2001, an increase of $196,000, or 5%. This increase was primarily attributable to the inclusion of IES and MDT in our results beginning with the third quarter, which increased general and administrative expenses by approximately $839,000. This increase was offset by decrease in general and expenses of $643,000, resulting from:

- the dismissal of our litigation with Electrofuel Inc., which resulted in a decrease in litigation-related legal expenses; and
- the settlement of our dispute with a former employee on terms that resulted in a savings to us over the amount that we had set aside on our books.

***Financial income*.** Financial income, net of interest expenses and exchange differentials, totaled approximately $100,000 in 2002 compared to $263,000 in 2001, a decrease of $163,000, or 62%. This decrease was due primarily to lower interest rates and lower balances of invested funds as a result of our use of the proceeds of private placements of our securities.

Income taxes. We and our Israeli subsidiary EFL incurred net operating losses during 2002 and 2001 and, accordingly, we were not required to make any provision for income taxes. MDT had taxable income, but we may use EFL's losses to offset MDT's income, and accordingly MDT has made no provision for income taxes.

***Amortization of intangible assets*.** Amortization of intangible assets totaled $649,000 in 2002, compared to $0 in 2001**,** due to the inclusion of IES and MDT in our 2002 results. Of this $649,000 increase, $551,000 was attributable to the inclusion of IES in our results in 2002 and $98,000 was attributable to the inclusion of MDT in our results in 2002.

***Net loss from continuing operations*.** Due to the factors cited above, we reported a net loss from continuing operations of $4.9 million in 2002, compared to a net loss of $4.0 million in 2001, an increase of $913,000, or 22%.

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

Net loss from discontinued operations in 2002 was $13.6 million, compared to $13.3 million in 2001, an increase of $306,000, or 2%. This increase was the result of a write-off of fixed inventory and assets in the amount of $7.1 million in connection with our discontinuation of the operations relating to the retail sales of our consumer battery products at the end of the third quarter of 2002, which was not entirely offset by the elimination of the losses from these discontinued operations beginning with the fourth quarter of 2002.

Net loss. Due to the factors cited above, we reported a net loss of $17.3 million in 2002, compared to a net loss of $18.5 million in 2001, an increase of $1.2 million, or 7%.

Fiscal Year 2001 compared to Fiscal Year 2000

Preliminary Note. We have broken down the results for the years ended December 31, 2001 and 2000 in accordance with the continuing operations divisions that we maintained at the time: Electric Vehicle, and Defense and Security Products (which at the time consisted of only our CECOM batteries and our water-activated batteries). Beginning in 2002, both of these divisions were combined into a single division called Electric Fuel Batteries. It is therefore appropriate to compare our overall results from continuing operations in 2001 and 2000 with the results of our Electric Fuel Battery Division in 2002.

***Revenues*.** Revenues from continuing operations for the year ended December 31, 2001

totaled $2.1 million, compared to $1.5 million for 2000, an increase of $604,000, or 40%.

During 2001, we recognized revenues from continuing operations from the sale of lifejacket lights and portable high-power zinc-air fuel cell packs for military use. We also recognized revenues from subcontracting fees received in connection with the United States Department of Transportation (DOT) program which began in 1998 and, after we completed Phase I in July of 2000, was extended in the fourth quarter of 2000. We participate in this program as a member of a consortium seeking to demonstrate the ability of the Electric Fuel battery system to power a full-size, all-electric transit bus. The total program cost of Phase II is approximately $2.7 million, 50% of which will be covered by the DOT subcontracting fees. Subcontracting fees cover less than all of the expenses and expenditures associated with our participation in the program. We also received electric vehicle revenues during 2001 from our German consortium (EFRB) project. In 2000, we derived revenues from continuing operations principally from the sale of lifejacket lights. Additionally, we also recognized revenues from activities related to the DOT program.

In 2001, revenues were $894,000 for the Electric Vehicle Division (compared to $310,000 in 2000**,** an increase of $584,000, or 188%) and $1.2 million for the Defense and Security Products Division (formerly known as the Defense and Safety Products Division) (compared to $1.2 million in 2000**,** unchanged).

The increase in revenues from the Electric Vehicle Division in 2001 was the result of our having received the German consortium (EFRB) project, described above. This project generated revenues of $471,000 in 2001.

Cost of revenues and gross profit. Cost of revenues totaled $2.0 million during 2001, compared to $1.5 million in 2000, an increase of $506,000, or 34%. This increase was primarily the result of the increase in our Electric Vehicle revenues in 2001, as described above, which also resulted in an increase in cost of goods sold.

Gross profit was $101,000 during 2001, compared to $4,000 during 2000, an increase of $97,000. This increase was the direct result of all factors presented above, most notably the increased electric vehicle revenues during 2001 from our German consortium (EFRB) project.

***Research and development expenses, net*.** Research and development expenses less royalty-bearing grants for 2001 were $456,000, compared to $499,000 in 2000, a decrease of $43,000, or 9%.

Research and development expenses were reduced by $0 of royalty bearing grants from the BIRD Foundation during 2001 (compared to $195,000 in 2000).

Direct expenses for our two divisions for the fiscal year ended December 31, 2001 were $907,000 for the Electric Vehicle Division ($634,000 in 2000, an increase of $273,000, or 43%), and $1.4 million for the Defense and Security Products Division ($1.1 million in 2000, an increase of $268,000, or 24%). The increase of expenses in the Electric Vehicle Division was the result of progress that was made in phase II of the FTA program and the German program.

Net costs of fixed assets (net of accumulated depreciation) at December 31, 2001 in the Electric Vehicle and Defense and Security Products Divisions were $666,000 and $853,000, respectively.

***Selling expenses*.** Selling expenses for the year ended December 31, 2001 were $106,000, compared to $127,000 in 2000, a decrease of $21,000, or 16%.

***General and administrative expenses*.** General and administrative expenses for 2001 were $3.8 million compared to $3.3 million in 2000, an increase of $521,000, or 16%. This increase in expenses was the result of the following factors (in descending order of importance):

- Increases in management salaries and in accruals related to our senior employees, accounting for approximately $150,000 of the increase in general and administrative expenses;
- Non-cash write-down of notes receivable from certain stockholders reflecting a diminution in the market value of securities collateralizing such notes, accounting for approximately $100,000 of the increase in general and administrative expenses; and
- An increase in expenses related to travel, consultants, and directors and officers liability insurance, accounting for approxi-

mately $200,000 of the increase in general and administrative expenses.

***Financial income*.** Financial income, net of interest expenses and exchange differentials, totaled approximately $263,000 in 2001 compared to $544,000 in 2000, a decrease of $281,000, or 52%, due primarily to lower interest rates and lower balances of invested funds as a result of our use of the proceeds of private placements of our securities conducted in May and November 2000, which was only partially offset by income from the proceeds of private placements of our securities conducted in May, November and December 2001, as well as a decrease in interest income from certain shareholder loans.

Income taxes. We and our Israeli subsidiary EFL incurred net operating losses during 2001 and 2000 and, accordingly, we were not required to make any provision for income taxes.

***Net loss from continuing operations*.** Due to the factors cited above, particularly the increase in general and administrative expenses and the decrease in financial income, we reported a net loss of $4.0 million in 2001, compared to a net loss of $3.4 million in 2000, an increase of $641,000, or 19%.

***Net loss from discontinued operations*.** Net loss from discontinued operations was $13.3 million in 2001, compared to $8.6 million in 2000, an increase of $4.7 million, or 55%. This increase was primary the result of the following factors (in descending order of importance):

- Our sales and marketing expenses increased in 2001 compared to 2000, primarily because of increased sales and marketing expenses in the United States and the United Kingdom, accounting for an increase in sales and marketing of approximately $2.1 million;
- Our revenues derived from discontinued operations were lower by an amount of $620,000, primarily because a single large order that we received from one customer (Wal-Mart) during 2000 was not repeated in 2001, thereby resulting in fewer products sold. An additional factor in the decrease in revenues was our reduction in the price at which we sold our products during 2001, which resulted in lower revenues from the products we did sell;
- Products that we had sold that were still subject to possible return continued to be carried as inventory. Once it was clear that these products would not be returned, we decreased the inventory, resulting in an increase in cost of revenues of approximately $615,000;
- We took an inventory write-off as a result of a decision to discontinue production and sale of most disposable battery products in response to low consumer demand for those products, accounting for an increase in cost of revenues of approximately $440,000;
- When we lowered the retail prices of our products, we recognized losses on those of our products that we carried in inventory due to the principle of presenting inventory at the lower of cost or market value, accounting for an increase in cost of revenues of approximately $400,000;
- We increased our accruals for doubtful debts because a greater portion of our accounts receivable was aged over six months, accounting for approximately $300,000 of the increase in general and administrative expenses;
- We concentrated on production of chargers, which were more popular than disposable batteries but which have higher production costs and hence a higher gross loss than do the disposable batteries that we emphasized in 2000, accounting for an increase in cost of revenues of approximately $300,000; and
- Some of our equipment began to be depreciable beginning in the second half of 2001, which resulted in an increase in our cost of revenues during 2001 of the amount of the depreciation, which was approximately $200,000.

The above factors were offset to some extent by reduction in research and development expenses related to our discontinued operation in 2001 compared to 2000, primarily as a result of our move from a company primarily engaged in research and development to a company engaged in production.

Net loss. Due to the factors cited above, we reported a net loss of $17.3 million in 2001 (without taking into account a deemed dividend to certain shareholders as a result of the repricing of warrants held by certain of our investors, as described in Note 12.g.2 of the Notes to the Con-

solidated Financial Statements), compared to a net loss of $12.0 million in 2000, and increase of $5.3 million, or 44%.

Liquidity and Capital Resources

As of December 31, 2002, we had cash and cash equivalents of approximately $1.5 million, and certificates of deposit due within one year amounting to $633,000, compared with $12.7 million as of December 31, 2001, a decrease of $11.2 million, or 88%. The decrease in cash was primarily the result of losses incurred in our consumer battery division, which we shut down in the third quarter of 2002, and the costs of the acquisitions of IES and MDT.

We used available funds in 2002 primarily for the acquisition of IES and MDT, and other working capital needs. We increased our investment in fixed assets by $667,000 (including fixed assets used in discontinued operations) during the year ended December 31, 2002, primarily in the Electric Fuel Batteries Division. Our fixed assets amounted to $2.6 million as at year end after the write-off of net fixed assets in the amount of $4.5 million due to discontinuation of our consumer battery business.

Net cash used in operating activities from continuing operations for 2002 and 2001 was $3.5 million and $2.5 million, respectively, an increase of $1.0 million, or 40%. This increase was primarily the result of an increased net loss, an increase in inventory and a decrease in accounts payable and in accruals in comparison to 2001.

Net cash used in investing activities for 2002 and 2001 was $5.4 million and $1.3 million, respectively, an increase of $4.1 million, or 319%. This increase was primarily the result of our investment in the acquisition of IES and MDT.

Net cash provided by financing activities for 2002 and 2001 was $3.1 million and $15.7 million, respectively, a decrease of $12.6 million, or 80%. This decrease was primarily the result of lower amounts of funds raised through sales of our common stock in 2002 compared to 2001.

Our Israeli subsidiary EFL presently has a line of credit with the First International Bank of Israel Ltd. (FIBI) of up to $750,000, secured by such security as we and the bank shall agree upon from time to time. This credit facility imposes financial and other covenants on Arotech and EFL. As of December 31, 2002, the bank had issued letters of credit and bank guarantees totaling approximately $35,000.

During 2002, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately $113,000.

On January 15, 2002 we issued and sold to Grenville Finance Ltd., for an aggregate purchase price of $750,000, an aggregate of 441,176 shares of common stock.

On January 23, 2002 we issued and sold to various institutional investors affiliated with the Special Situation funds, for an aggregate purchase price of $2,480,000, an aggregate of 1,600,000 shares of common stock.

On December 31, 2002 we issued and sold to various institutional investors we issued and sold to three institutional investors an aggregate $3,500,000 principal amount of 9% Secured Convertible Debentures due June 30, 2005, as more fully described under “Item 5. Market For Registrant’s Common Equity and Related Stockholder Matters – Recent Sales of Unregistered Securities,” above.

We have approximately $4.0 million in long term debt outstanding, and approximately $1.3 million in short-term debt.

Approximately 22.9% of the stock of our Israeli-based subsidiary EFL is deemed to be beneficially owned (indirectly through their ownership of our stock by application of certain attribution rules) by four United States citizens: Leon S. Gross, Austin W. Marxe and David M. Greenhouse, and Robert S. Ehrlich. (Information with respect to the stockholdings of Messrs. Marxe and Greenhouse is based on a Schedule 13G filed with the Securities and Exchange Commission on February 11, 2002, as amended on February 13, 2003.) If at any time in the future, more than 50% of either (i) the voting power of our stock, or (ii) the total value of our stock, is held or deemed to be held by five or fewer individuals (including, if applicable, those individuals who currently own an aggregate of 22.9% of our stock) who are United States citizens or residents, EFL would satisfy the foreign personal holding company stock ownership test under the Internal Revenue Code and we could be subject to additional U.S. taxes on any undistributed foreign personal holding company income of EFL. For 2002, EFL had no income which would qualify as undistributed foreign personal holding company income. However, no assurance can be given that in the

be given that in the future EFL will not have income that qualifies as undistributed foreign personal holding company income.

We believe that our present cash position and anticipated cash flows from operations should be sufficient to satisfy our estimated cash requirements through the next year.

Impact of Inflation and Currency Fluctuations

Historically, the majority of our revenues have been in U.S. dollars. The United States dollar cost of our operations in Israel, with regard to expenses incurred in NIS, is influenced by the extent to which an increase in the rate of inflation in Israel is not offset by the devaluation of the NIS in relation to the dollar. In the past two years, inflation in Israel has been more than fully compensated by the devaluation of the NIS and, accordingly, the dollar cost of our NIS expenses has decreased. Even if the recent trend is reversed (as was the case in previous years), we do not believe that continuing inflation in Israel or delays in the devaluation of the NIS are likely to have a material adverse effect on us, except to the extent that such circumstances have an impact on Israel's economy as a whole. In the years ended December 31, 2000, 2001 and 2002, the annual rates of inflation in Israel were 0.0%, 1.4% and 6.5%, respectively, compared to the devaluation of the NIS against the dollar during such periods of (2.7)%, 9.3% and 7.3%, respectively. Additionally, our $2.6 million contract to supply simulation training systems to the largest regional police division in Germany is denominated in Euros.

Effective Corporate Tax Rate

Our production facilities in Israel have been granted "Approved Enterprise" status under the Israel Law for Encouragement of Capital Investments, 5719-1959, and consequently are eligible for certain tax benefits for seven to ten years after they first generate taxable income (provided the maximum period as prescribed by law has not elapsed). Under this law, a company may either accept government grants and receive a reduced tax rate, or forego government grants and receive an alternate package of tax benefits that includes a complete exemption from certain taxes. We have elected to receive a grant of funds together with a reduced tax rate for the aforementioned period.

EFL's effective corporate tax rate may be affected by the classification of certain items of income as being "approved income" for purposes of the Approved Enterprise law, and hence subject to a lower tax rate (25% to 10%, depending on the extent of foreign ownership of EFL – presently 15%) than is imposed on other forms of income under Israeli law (presently 36%). The effective tax upon income we distribute to our stockholders would be increased as a result of the withholding tax imposed upon dividends distributed by EFL to Arotech, resulting in an overall effective corporate tax rate of approximately 28% for income arising from EFL's Approved Enterprises and 44% regarding other income.

Arotech and EFL have incurred net operating losses or had earnings arising from tax-exempt income during the years ended December 31, 2000, 2001 and 2002 and accordingly no provision for income taxes was required. Taxes in these entities paid in 2000, 2001 and 2002 are primarily composed of United States federal alternative minimum taxes.

As of December 31, 2002, we had U.S. net operating loss carry forwards of approximately $15 million that are available to offset future taxable income, expiring primarily in 2015, and foreign net operating loss carry forwards of approximately $93 million, which are available indefinitely to offset future taxable income.

ERNST & YOUNG

REPORT OF INDEPENDENT AUDITORS

To the Shareholders of

ELECTRIC FUEL CORPORATION

We have audited the accompanying consolidated balance sheets of Electric Fuel Corporation (doing business as Arotech Corporation) (the "Company") and its subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2002 and 2001, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

Tel Aviv, Israel
February 27, 2003

KOST FORER & GABBAY
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ELECTRIC FUEL CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
In U.S. dollars

	December 31,	
	2002	2001
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,457,526	$12,671,754
Restricted collateral deposit and other restricted cash	633,339	–
Trade receivables (net of allowance for doubtful accounts in the amounts of $40,636 and $39,153 as of December 31, 2002 and 2001, respectively)	3,776,195	765,402
Other accounts receivable and prepaid expenses	1,032,311	448,651
Inventories	1,711,479	523,366
Assets of discontinued operations	349,774	8,422,082
Total current assets	8,960,624	22,831,255
LOANS TO SHAREHOLDERS	–	501,288
SEVERANCE PAY FUND	1,025,071	854,891
PROPERTY AND EQUIPMENT, NET	2,555,249	2,220,806
GOODWILL	4,954,981	–
OTHER INTANGIBLE ASSETS, NET	2,567,457	–
	$20,063,382	$26,408,240

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

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

	December 31,	
	2002	2001
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short term bank loans	$ 108,659	$ –
Trade payables	2,900,117	791,576
Other accounts payable and accrued expenses	2,009,109	1,222,653
Current portion of promissory note due to purchase of a subsidiary	1,200,000	–
Liabilities of discontinued operations	1,053,798	1,860,107
Total current liabilities	7,271,683	3,874,336
LONG TERM LIABILITIES		
Accrued severance pay	2,994,233	3,125,848
Promissory note due to acquisition of a subsidiary	516,793	–
Total long-term liabilities	3,511,026	3,125,848
COMMITMENTS AND CONTINGENT LIABILITIES		
MINORITY INTEREST	243,172	–
SHAREHOLDERS' EQUITY:		
Share capital –		
Common stock – $0.01 par value each;		
Authorized: 100,000,000 shares as of December 31, 2002 and 2001; Issued: 35,701,594 shares and 29,059,469 shares as of December 31, 2002 and 2001, respectively; Outstanding – 35,146,261 shares and 28,504,136 shares as of December 31, 2002 and 2001, respectively	357,017	290,596
Preferred shares – $0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2002 and 2001; No shares issued and outstanding as of December 31, 2002 and 2001	–	–
Additional paid-in capital	114,082,584	105,686,909
Accumulated deficit	(100,673,619)	(82,169,261)
Deferred stock compensation	(12,000)	(18,000)
Treasury stock, at cost (common stock – 555,333 shares as of December 31, 2002 and 2001)	(3,537,106)	(3,537,106)
Notes receivable from shareholders	(1,177,589)	(845,081)
Accumulated other comprehensive loss	(1,786)	–
Total shareholders' equity	9,037,501	19,408,057
	$ 20,063,382	$ 26,408,241

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

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

	Year ended December 31,		
	2002	2001	2000
Revenues:			
Products	$ 5,944,370	$ 1,670,634	$ 1,179,500
Services	462,369	422,998	310,442
Total revenues	6,406,739	2,093,632	1,489,942
Cost of revenues	4,421,748	1,992,636	1,486,300
Gross profit	1,984,991	100,996	3,642
Operating expenses:			
Research and development, net	685,919	455,845	498,895
Selling and marketing expenses	1,309,669	105,977	126,893
General and administrative expenses	4,023,103	3,827,544	3,306,716
Amortization of intangible assets	623,543	–	–
In-process research and development write-off	26,000	–	–
Total operating costs and expenses	6,668,234	4,389,366	3,932,504
Operating loss	(4,683,243)	(4,288,370)	(3,928,862)
Financial income, net	100,451	262,581	544,181
Loss before minority interest in earnings of a subsidiary	(4,582,792)	(4,025,789)	(3,384,681)
Minority interest in earnings of a subsidiary	(355,360)	–	–
Net loss from continuing operations	(4,938,152)	(4,025,789)	(3,384,681)
Net loss from discontinued operations (including loss on disposal of $4,446,684)	(13,566,206)	(13,260,999)	(8,596,277)
Net loss	$ (18,504,358)	$ (17,286,788)	$ (11,980,958)
Deemed dividend to certain shareholders of Common stock	$ –	$ (1,196,667)	$ –
Net loss attributable to shareholders of Common stock	$ (18,504,358)	$ (18,483,455)	$ (11,980,958)
Basic and diluted net loss per share from continuing operations	$ (0.15)	$ (0.21)	$ (0.17)
Basic and diluted net loss per share from discontinued operations	$ (0.42)	$ (0.55)	$ (0.45)
Basic and diluted net loss per share	$ (0.57)	$ (0.76)	$ (0.62)
Weighted average number of shares used in computing basic and diluted net loss per share	32,381,502	24,200,184	19,243,446

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

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

	Common stock Shares	Common stock Amount	Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Accumulated other comprehensive income (loss)	Treasury stock	Total comprehensive loss	Notes receivable from shareholders	Total shareholders' equity
Balance as of January 1, 2000	15,728,387	$ 157,284	$60,110,815	$(52,901,515)	–	–	$ (37,731)		$ (3,086,494)	$ 4,242,359
Payment of interest and principal on notes receivable from shareholders	–	–	–	–	–	–	–		2,705,052	2,705,052
Issuance of shares to investors, net	2,477,952	24,780	18,249,373	–	–	–	–		–	18,274,153
Issuance of shares to service providers	35,000	350	524,650	–	–	–	–	–	–	525,000
Exercise of options	1,880,156	18,802	6,936,355	–	–	–	–	–	(3,723,456)	3,231,701
Exercise of warrants	1,301,196	13,011	2,437,295	–	–	–	–	–		2,450,306
Deferred stock compensation	–	–	37,924	–	(37,924)	–	–		–	–
Stock compensation related to options repriced	–	–	26,250	–		–	–		–	26,250
Amortization of deferred stock compensation	–	–	–	–	20,684	–	–		–	20,684
Stock compensation related to options issued to consultants	–	–	769,128	–	–	–	–		–	769,128
Accrued interest on notes receivable from shareholders	–	–	–	–	–	–	–		(185,306)	(185,306)
Comprehensive loss :										
Net loss	–	–	–	(11,980,958)	–	–	–	(11,980,958)	–	(11,980,958)
Total comprehensive loss								$ (11,980,958)		
Balance as of December 31, 2000	21,422,691	$ 214,227	$89,091,790	$(64,882,473)	$ (17,240)	$ –	$ (37,731)		$ (4,290,204)	$ 20,078,369

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

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

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Total comprehensive loss	Notes receivable from shareholders	Total shareholders' equity
	Shares	Amount							
Balance as of January 1, 2001	21,422,691	$ 214,227	$89,091,790	$ 64,882,473)	$ (17,240)	$ (37,731)		$ (4,290,204)	$ 20,078,369
Repurchase of common shares from shareholders and repayment of the related interest and principal of notes from shareholders	–	–	228,674	–	–	(3,499,375)		3,470,431	199,730
Issuance of shares to investors, ne	6,740,359	67,405	14,325,941	–	–	–		–	14,393,346
Retirement of shares	(3,000)	(30)	(17,970)	–	–	–		18,000	–
Issuance of shares to service providers	346,121	3,461	536,916	–	–	–		–	540,377
Exercise of options	219,965	2,200	512,089	–	–	–		(43,308)	470,981
Exercise of warrants	333,333	3,333	836,667	–	–	–	–	–	840,000
Deferred stock compensation	–	–	18,000	–	(18,000)	–		–	–
Amortization of deferred stock compensation	–	–	(6,193)	–	17,240	–		–	11,047
Stock compensation related to options issued to consultants	–	–	139,291	–	–	–		–	139,291
Stock compensation related to options to consultants repriced	–	–	21,704	–	–	–		–	21,704
Comprehensive loss:									
Net loss	–	–	–	(17,286,788)	–	–	(17,286,788)	–	(17,286,788)
Total comprehensive loss							$(17,286,788)		
Balance as of December 31, 2001	29,059,469	$ 290,596	$105,686,909	$(82,169,261)	$ (18,000)	$ (3,537,106)		$ (845,081)	$ 19,408,057

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

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

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

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

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

	Year ended December 31,		
	2002	2001	2000
Cash flows from operating activities:			
Net loss	(18,504,358)	(17,286,788)	(11,980,958)
Less loss for the period from discontinued operations	13,566,206	13,260,999	8,596,277
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minority interest in earnings of subsidiary	355,360	–	–
Depreciation	473,739	530,013	514,242
Amortization of intangible assets	623,543	–	–
In-process research and development write-off	26,000	–	–
Accrued severance pay, net	(357,808)	530,777	209,999
Amortization of deferred stock compensation	6,000	17,240	9,010
Impairment and write-off of loans to shareholders	542,317	206,005	–
Compensation expenses related to repurchase of treasury stock	–	228,674	–
Write-off of inventories	116,008	–	–
Amortization of compensation related to options issued to consultants and repriced options issued to employees and consultants	–	–	233,636
Compensation expenses related to shares issued to employees	13,000	–	–
Accrued interest on notes receivable from shareholders	–	36,940	(230,922)
Interest accrued on promissory notes due to acquisition	29,829	–	–
Interest accrued on restricted collateral deposit	(3,213)	–	–
Capital (gain) loss from sale of property and equipment	(4,444)	815	(6,330)
Decrease (increase) in trade receivables	389,516	(452,425)	35,741
Decrease (increase) in other accounts receivable and prepaid expenses	257,218	616,040	(595,744)
Increase in inventories	(520,408)	(128,897)	(98,092)
Increase (decrease) in trade payables	(62,536)	(301,075)	(85,996)
Increase (decrease) in other accounts payable and accrued expenses	(423,664)	286,511	(40,191)
Net cash used in operating activities from continuing operations (reconciled from continuing operations)	(3,477,695)	(2,455,171)	(3,439,328)
Net cash used in operating activities from discontinued operations (reconciled from discontinued operations)	(5,456,912)	(10,894,660)	(10,523,852)
Net cash used in operating activities	(8,934,607)	(13,349,831)	(13,963,180)

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

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

	Year ended December 31,		
	2002	2001	2000
Cash flows from investing activities:			
Purchase of property and equipment	(275,540)	(513,746)	(552,044)
Payment to suppliers for purchase of property and equipment from previous year	(39,336)	(43,883)	–
Loans granted to shareholders	(4,529)	–	(958,156)
Repayment of loans granted to shareholders	–	–	225,097
Proceeds from sale of property and equipment	8,199	40,217	57,867
Acquisition of IES [(1)]	(2,958,083)	–	–
Acquisition of MDT [(2)]	(1,201,843)	–	–
Increase in restricted cash	(595,341)	–	–
Net cash used in discontinued operations (purchase of property and equipment)	(290,650)	(761,555)	(2,306,467)
Net cash used in investing activities	(5,357,123)	(1,278,967)	(3,533,703)
Cash flows from financing activities:			
Proceeds from issuance of shares, net	3,230,000	14,393,346	18,150,404
Proceeds from exercise of options	113,350	470,981	3,231,701
Proceeds from exercise of warrants	–	840,000	2,450,306
Payment of interest and principal on notes receivable from shareholders	43,308	–	2,705,052
Profit distribution to minority	(412,231)	–	–
Increase in short term bank credit	108,659	–	–
Payment on capital lease obligation	(5,584)	–	–
Net cash provided by financing activities	3,077,502	15,704,327	26,537,463
Increase (decrease) in cash and cash equivalents	(11,214,228)	1,075,529	9,040,580
Cash and cash equivalents at the beginning of the year	12,671,754	11,596,225	2,555,645
Cash and cash equivalents at the end of the year	$ 1,457,526	$ 12,671,754	$ 11,596,225
Supplementary information on non-cash transactions:			
Purchase of property and equipment against trade payables	$ –	$ 39,336	$ 227,230
Purchase of treasury stock in respect of notes receivable from shareholders	$ –	$ 3,499,375	$ –
Retirement of shares issued under notes receivables	$ –	$ 18,000	$ –
Issuance of shares to consultants in respect of prepaid interest expenses	$ 236,250	$ –	$ 120,000
Exercise of options against notes receivable	$ 36,500	$ 43,308	$ 3,723,456
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	$ 10,640	$ 19,106	$ 25,537

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

In U.S. dollars

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

Working capital, excluding cash and cash equivalents	$ 1,197,000
Property and equipment, net	396,776
Capital lease obligation	(15,526)
Technology	1,515,000
Existing contracts	46,000
Covenants not to compete	99,000
In process research and development	26,000
Customer list	527,000
Trademarks	439,000
Goodwill	4,068,726
	8,298,976
Issuance of shares	(3,653,929)
Issuance of promissory note	(1,686,964)
	$ 2,958,083

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

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

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

NOTE 1:– GENERAL

a. Electric Fuel Corporation d/b/a Arotech Corporation ("EFC," "Electric Fuel," or the "Company") and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles, and in the design, development and commercialization of its proprietary zinc-air battery technology for electric vehicles and defense applications. The Company is primarily operating through Electric Fuel Ltd. ("EFL") a wholly-owned Israeli based subsidiary, IES Interactive Training, Inc. ("IES"), a wholly-owned U.S. subsidiary, and MDT Protective Industries, an Israeli concern in which the Company has a 51% interest. The Company's production and research and development operations are primarily located in Israel and in the United States.

In addition to EFL and MDT, the Company has three wholly-owned non-operating foreign subsidiaries, in the U.K ("EFL U.K."), in Germany ("GmbH") and in the Netherlands ("BV"). The Company also has three subsidiaries in the United States in addition to IES: Electric Fuel Transportation Corp. (Delaware), Instant Power Corporation (Delaware), and I.E.S. Defense Services, Inc. (Delaware).

b. Acquisition of IES:

In August 2, 2002, the Company entered into an asset purchase agreement among I.E.S. Electronics Industries U.S.A., Inc. ("IES"), its direct and certain of its indirect shareholders, and its wholly-owned Israeli subsidiary, EFL, pursuant to the terms of which it acquired substantially all the assets, subject to substantially all the liabilities, of IES, a developer, manufacturer and marketer of advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel.

Beginning in 2002 and even before, management began to weigh seriously the considerable costs of competing in the retail consumer products market and of continuing as a company whose sole products consisted of various forms of batteries, and began to look to acquire profitable companies with positive cash flow and strong, in-place management that would expand in the non-battery field on the Company's Zinc-Air batteries for the defense industry, which were then just beginning to become an important part of the Company's business. Management concentrated its search almost exclusively on companies with a strong presence in the defense and security products and services industry, in an attempt to emphasize the Company's growing defense and security battery business, and out of a desire to re-position the Company away from its historical roots as a battery company. In keeping with this decision, management found IES, a profitable company that had substantial positive cash flow, strong management, and accordingly, management believed, a potential for significant earnings growth in the near term while offering the Company the opportunity to reposition itself away from the consumer products market and into the defense and security market. The nature of this acquisition necessarily involved a company whose primary assets were its trademarks and name recognition, its intellectual property, such as technology, and its broad customer base, resulting in a significant allocation of the purchase price to intangible assets. The acquisition resulted in a significant allocation to goodwill due to the potential for significant growth in the earnings of IES resulting from the potential for a significant increase in IES's international sales.

The Company intends to continue to use the assets purchased in the conduct of the business formerly conducted by IES (the "Business"). The acquisition has been accounted under the purchase method of accounting. Accordingly, all assets and liabilities were acquired at the values on such date, and the Company consolidated IES's results with its own commencing at such date.

The assets purchased consisted of the current assets, property and equipment, and other intangible assets used by IES in the operations of the Business. The consideration for the assets and liabilities purchased consisted of (i) cash and promissory notes in an aggregate amount of $4,800,000 ($3,000,000 in cash and $1,800,000 in promissory notes, which was recorded at its fair value in the amount of $1,686,964) (see Note 9), and (ii) the issuance, with registration rights, of a total of 3,250,000 shares of the Company's common stock, $.01 par value per share, having a value of approximately $3,653,929, which shares are the subject of a voting agreement on the part of IES and certain of its affiliated companies. The value of 3,250,000 shares issued was determined based

on the average market price of EFC's Common stock over the period including two days before and after the terms of the acquisition were agreed to. The total consideration of $8,390,893 (including $50,000 of transaction costs) was determined based upon arm's-length negotiations between the Company and IES and IES's shareholders.

Based upon a valuation of tangible and intangible assets acquired, Electric Fuel has allocated the total cost of the acquisition to I.E.S.'s assets as follows:

Cash	$ 50,988
Trade receivables	2,023,299
Inventory	284,341
Property and equipment	396,776
Other receivables	101,547
Technology (four year useful life)	1,515,000
Existing contracts (one year useful life)	46,000
Covenants not to compete (five year useful life)	99,000
In process research and development	26,000
Customer list (seven year useful life)	527,000
Trademarks (indefinite useful life)	439,000
Goodwill	4,068,726
Total assets acquired	9,577,677
Accounts payable and accrued expenses	(1,010,649)
Lease obligations	(15,526)
Deferred warranty revenues	(160,609)
Total liabilities assumed	(1,186,784)
Net assets acquired	$ 8,390,893

Intangible assets in the amount of $2,187,000 have a weighted-average useful life of approximately 4 years. The $4,068,726 of goodwill was assigned to the Defense and Security segment.

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

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

1. To determine the value of the Company's net current assets, property and equipment, and net liabilities; the Cost Approach was used, which requires that the assets and liabilities in question be restated to their market values. Per valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.
2. The amount of the excess cost attributable to technology of Range 2000, 3000 and A2Z Systems is $1,515,000 and was determined using the Income Approach.
3. The value assigned to purchased in-process technology relates to two projects "Black Box" and A2Z trainer. The estimated fair value of the acquired in-process research and development platforms that had not yet reached technological feasibility and had no alternative future use amounted to $26,000. Technological feasibility or commercial viability of these projects was established at the acquisition date. These products were considered to have no alternative future use other than the technological indications for which they were in development. Accordingly, these amounts were immediately expensed in the consolidated statement of operations on the acquisition date in accordance with FASB Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method." The estimated fair values of these platforms were determined using discounted cash flow models. Projects were estimated to be 4% complete; estimated costs to completion of these platforms were approximately $200,000 and $25,000, respectively, and discount rate of 25% was used.
4. The value assigned to the customer list is amounted to $527,000. Management states that its customers have generally been very loyal to the Company's products; most present customers will purchase add-ons or up-grades to their IES simulator systems in the future, and some will purchase additional warranties for the systems they possess. The Company's customer list has been valued using the Income Approach.
5. The value assigned to the trademarks is amounted to $439,000 and was determined based on the Cost Approach. In doing so, it is assumed that historical expenditures for advertising are a reasonable proxy for the future benefits expected from the Trademarks and Trade names.

6. Value of IES's Covenant Not to Compete (CNC) was valued at the amount of $99,000. One of IES's intangible assets is its Covenant Not to Compete. Asset Purchase Agreement precludes the former parent company, and its principals and key employees from competing with IES for five years from the Valuation Date. According to management, among the individuals covered by the CNC are the original developers of the Range 2000 and A2Z systems. Estimated CNC's value was determined using the Income Approach. The estimated value of the CNC is the sum of the present value of the cash flows that would be lost if the CNC was not in place. Specifically, the value of the CNC is calculated as the difference between the projected cash flows if the former parent company or its principals were to start competing immediately and the projected cash flows if those parties start competing after five years, when the CNC expires.
7. The excess of the cost of IES over the net of the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill in the amount of $4,068,726. An acquired workforce in the amount of $333,000 that does not meet the separability criteria has been included in the amount recognized as goodwill.

c. Acquisition of MDT:

On July 1, 2002, the Company entered into a stock purchase agreement with all of the shareholders of M.D.T. Protective Industries Ltd. ("MDT"), pursuant to the terms of which the Company purchased 51% of the issued and outstanding shares of MDT, a privately-held Israeli company that specializes in using sophisticated lightweight materials and advanced engineering processes to armor vehicles. The Company also entered into certain other ancillary agreements with MDT and its shareholders and other affiliated companies.

Beginning in 2002 and even before, management began to weigh seriously the considerable costs of competing in the retail consumer products market and of continuing as a company whose sole products consisted of various forms of batteries, and began to look to acquire profitable companies with positive cash flow and strong, in-place management that would expand in the non-battery field on the Company's Zinc-Air batteries for the defense industry, which were then just beginning to become an important part of the Company's business. Management concentrated its search almost exclusively on companies with a strong presence in the defense and security products and services industry, in an attempt to emphasize the Company's growing defense and security battery business, and out of a desire to re-position the Company away from its historical roots as a battery company. In keeping with this decision, management found MDT, a profitable company that had substantial positive cash flow, strong management, and, management believed, a potential for significant earnings growth in the near term while offering the Company the opportunity to re-position itself away from the consumer products market and into the defense and security market. The nature of this acquisition necessarily involved a company whose primary assets were its intellectual property, such as technology, and its broad customer base, resulting in a significant allocation of the purchase price to intangible assets. The acquisition resulted in the significant allocation to the goodwill due to the following components: the potential for accelerating MDT's efforts to offer its products internationally, shortening the time to market for MDT's new products; future versions, which are expected to be developed over the next years, based upon original MDT concepts and technology.

The Acquisition was accounted for under the purchase method of accounting and results of MDT's operations have been included in the consolidated financial statements since that date. The total consideration of $1,767,877 for the shares purchased consisted of (i) cash in the aggregate amount of 5,814,000 New Israeli Shekels ($1,231,780), and (ii) the issuance, with registration rights, of an aggregate of 390,638 shares of our common stock, $0.01 par value per share, having a value of approximately $439,077. The value of 390,638 shares issued was determined based on the average market price of EFC's Common stock over the period including two days before and after the terms of the acquisition were agreed to and announced. The total consideration of $1,767,877 (including $97,020 of transaction costs) was determined based upon arm's-length negotiations between the Company and MDT and MDT's shareholders.

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

Cash and cash equivalents	$ 25,019
Short-term bank deposits	153,427
Trade receivables	808,729
Inventory	196,411
Property and equipment	71,207
Other accounts receivable	82,254
Intangible assets	
Technology (five year useful life)	280,000
Customer base (five year useful life)	285,000
Goodwill	886,255
Total assets acquired	2,788,303
Liabilities assumed	
Accounts payable and other accrued expenses	(907,011)
Other current liabilities	(113,415)
Total liabilities assumed	(1,020,426)
Net assets acquired	$ 1,767,877

Intangible assets in the amount of $565,000 have a weighted-average useful life of approximately 5 years. The $886,255 of goodwill was assigned to the Defense and Security segment.

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

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

1. To determine the value of the Company's net current assets, net property, and equipment and net liabilities; the Cost Approach was used, which requires that the assets and liabilities in question be restated to their market values. Per estimation made, the book values for the current assets and liabilities were reasonable proxies for their market values.

2. The amount of the excess cost attributable to technology of optimal bulletproofing material and power mechanism for bulletproofed windows is $280,000 and was determined using the Income Approach on the basis of present value of cash flows attributable to the current technology over expected future life.

3. The value assigned to the customer base is amounted to $285,000. The Company's customer base has been valued using the Income Approach. The valuation of the customers' base derives mostly from relations with customers with no contracts. Most of the customers of MDT are from the defense sector and usually have long-standing relationships and tend to reorder from the Company.

4. The excess of the cost of MDT over the net of the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill in the amount of $886,255. An acquired workforce it the amount of $492,000 that does not meet the separablility criteria has been included in the amount recognized as goodwill.

d. Pro forma results:

The following unaudited proforma information does not purport to represent what the Company's results of operations would have been had the acquisitions occurred on January 1, 2001 and 2002, nor does it purport to represent the results of operations of the Company for any future period.

	Year ended December 31,	
	2002	**2001**
Revenues	$ 12,997,289	$ 12,369,749
Net loss from continuing operations	$ (6,103,771)	$(5,757,675)
Basic and diluted net loss per share for continuing operations	$ (0.18)	$ (0.21)
Weighted average number of shares of common stock in computation of basic and diluted net loss per share	34,495,185	27,840,822

The amount of the excess cost attributable to in-process research and development of IES and MDT in the amount of $26,000 has not been included in the pro forma information, as it does not represent a continuing expense.

e. Discontinued operations:

In September 2002, the Company committed to a plan to discontinue the operations of its retail sales of consumer battery products. The Company ceased the operations and disposed of all assets related to this segment by abandonment. The operations and cash flows of the consumer battery business have been eliminated from the operations of the entity as a result of the dis-

posal transaction. The Company has no intent to continue its activity in the consumer battery business. The Company's plan of discontinuance involved (i) termination of all employees whose time was substantially devoted to the consumer battery line and who could not be used elsewhere in the Company's operations, including payment of all statutory and contractual severance amounts, by the end of the fourth quarter of 2002, and (ii) disposal of the equipment and inventory used exclusively in the consumer battery business, since the Company has no reasonable expectation of being able to sell such equipment or inventory for any amounts substantially greater than the cost of disposal or shipping, by the end of the first quarter of 2003. The Company had previously reported its consumer battery business as a separate segment (Consumer Batteries) as called for by Statement of Financial Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS No. 131").

The results of operations including revenue, operating expenses and other income and expense of the retail sales of consumer battery products business unit for 2002, 2001 and 2000 have been reclassified in the accompanying statements of operations as discontinued operations. The Company's balance sheets at December 31, 2002 and 2001 reflect the net liabilities of the retail sales of consumer battery products business as net liabilities and net assets of discontinued operations within current liabilities and current assets.

At December 31, 2002, the estimated net losses associated with the disposition of the retail sales of consumer battery products business were approximately $13,566,206 for 2002. These losses included approximately $6,508,222 in losses from operations for the period from January 1, 2002 through the measurement date of December 31, 2002 and $7,057,684, reflecting a write-off of inventory and net property and equipment of the retail sales of consumer battery products business, as follows:

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

As a result of the discontinuance of consumer battery segment, the Company ceased to use property and equipment related to this segment. In accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long- Lived Assets" ("SFAS No. 144") such assets were considered to be impaired. Since the long-lived assets ceased to be used, the carrying amount of the assets was reduced to its salvage value, which is zero.

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

Summary operating results from the discontinued operation for the years ended December 31, 2002, 2001 and 2000 are as follows:

	Year Ended December 31,		
	2002	2001	2000
Revenues	$ 1,100,442	$ 1,939,256	$ 2,563,620
Cost of sales [1]	(5,293,120)	(5,060,966)	(3,073,142)
Gross loss	4,192,678	3,121,710	509,522
Operating expenses	4,926,844	10,139,289	8,086,755
Impairment of fixed assets	4,446,684	–	–
Operating loss	$ 13,566,206	$ 13,260,999	$ 8,596,277

[1] Including write-off of inventory in the amount of $2,611,000, $441,000 and $0 for the years ended December 31, 2002, 2001 and 2000.

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

A majority of the revenues of the Company and most of its subsidiaries is generated in U.S. dollars. In addition, a substantial portion of the Company's and most of its subsidiaries costs are incurred in U.S. dollars ("dollar"). Management believes that the dollar is the primary currency of the economic environment in which the Company and most of its subsidiaries operate. Thus, the functional and reporting currency of the Company and most of its subsidiaries is the dollar. Accordingly, monetary accounts main-

tained in currencies other than the U.S. dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transaction, gains and losses from the remeasured monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

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

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Inventories:

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

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

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

f. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants (no investment grants were received during 2002, 2001 and 2000).

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

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

The Company and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of an asset 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. Assets to be disposed of by sale are reported at the lower of the carrying amount or fair value less selling costs. As of December 31, 2002 no impairment losses have been identified.

g. Goodwill:

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

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. Fair value is determined using discounted cash flows, market multiples and market capitalization. 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.

h. Other intangible assets:

Intangible assets acquired in a business combination that are subject to amortization should be amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142. Intangible assets are amortized over their useful life (See Note 1b. and c). The Company evaluates the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset will be amortized prospectively over that revised remaining useful life.

i. Impairment of indefinite lived intangible asset

The acquired trademark is deemed to have an indefinite useful life because it is expected to contribute to cash flows indefinitely. Therefore, the trademark will not be amortized until its useful life is no longer indefinite The trademark will be tested for impairment in accordance FAS 142.

j. Revenue recognition:

The Company generates revenues primarily from sales of multimedia and interactive digital training systems and use-of-force simulators specifically targeted for law enforcement and firearms training and from service contracts related to such sales (through IES), from providing lightweight armoring services of vehicles (through MDT), and, to a lesser extent, from sale of zinc-air battery products for defense applications. To a lesser extent, revenues are generated from development services and long-term arrangements subcontracted by the U.S Government.

Revenues from products, training and simulation systems are recognized in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements ("SAB No. 101") when the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred, the seller's price to the buyer is fixed or determinable, no further obligation remains and collectibility is reasonably assured.

The Company does not grant a right of return to its customers.

Revenues from long-term agreements, subcontracted by the U.S. government, are recorded on a cost-sharing basis, when services are rendered and products delivered, as prescribed in the related agreements. Provisions for estimated losses are recognized in the period in which the likelihood of such losses is determined. As of December 31, 2002, no such estimated losses were identified.

Deferred revenues includes unearned amounts received from customers, but not recognized as revenues.

Revenues from development services are recognized based on Statement of Position No. 81-1 "Accounting for Performance of Construction - Type and Certain Production - Type Contracts" ("SOP 81-1"), using contract accounting on a percentage of completion method, based on completion of agreed-upon milestones and in accordance with the "Output Method" or based on the time and material basis. Provisions for estimated losses on uncompleted contracts are recognized in the period in which the likelihood of such losses is determined. As of December 31, 2002, no such estimated losses were identified.

Revenues from lightweight armoring services of vehicles are recorded when services are rendered and vehicle is delivered and no additional obligations exists.

k. Research and development cost:

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

l. Royalty-bearing grants:

Royalty-bearing grants from the Office of the Chief Scientist ("OCS") of the Israeli Ministry of

Industry and Trade and from the Israel-U.S. Binational Industrial Research and Development Foundation ("BIRD-F") for funding approved research and development projects are recognized at the time the Company is entitled to such grants on the basis of the costs incurred, and included as a deduction of research and development costs.

m. Income taxes:

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

n. Concentrations of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, restricted collateral deposit and other restricted cash, trade receivables and long-term loans to shareholders. Cash and cash equivalents are invested in U.S. dollar deposits with major Israeli, U.S. and U.K. banks. Such deposits in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company and its subsidiaries are mainly derived from sales to customers located primarily in the United States, Europe and Israel. Management believes that credit risks are moderated by the diversity of its end customers and geographic 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 has provided long-term loans to its shareholders, amounting to $733,059 as of December 31, 2002. The long-term loans are secured by the Company's shares and since the value of the Company's shares has decreased, the Company incurred a material loss during the years 2002 and 2001.

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

o. Basic and diluted net loss per share:

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

All outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share was 4,394,803, 3,170,334 and 2,812,725 for the years ended December 31, 2002, 2001 and 2000, respectively.

p. Accounting for stock-based compensation:

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

The Company applies SFAS No. 123 and Emerging Issue Task Force No. 96-18 "Accounting for Equity Instruments that are Issued to

Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

The fair value for the options to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 3.5%, 3.5-4.5%, and 6.5% for 2002, 2001 and 2000, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the Common Stock of 0.64 for 2002, 0.82 for 2001 and 0.95% for 2000; and a weighted-average expected life of the option of 10 years for 2002, 2001 and 2000.

	Year Ended December 31,		
	2002	2001	2000
Net income as reported	$ (18,504,358)	$ (18,483,455)	$ (11,980,958)
Add: Stock-based compensation expenses included in reported net loss	–	17,240	20,684
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(2,072,903)	(2,906,386)	(2,045,764)
Pro forma net loss	$ (20,577,261)	$ (21,372,601)	$ (14,006,038)
Loss per share:			
Basic and diluted, as reported	$ (0.57)	$ (0.76)	$ (0.62)
Diluted, pro forma	$ (0.64)	$ (0.88)	$ (0.73)

q. Fair value of financial instruments:

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

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

The carrying amount of the Company's long-term loans to shareholders approximates their fair value. The fair value was estimated using the fair market value of the secured Company's shares.

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

r. Severance pay:

The Company's liability for severance pay 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. Employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability for all of its employees is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

In addition and according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. The Company has made a provision for this special severance pay in accordance with Statement of Financial Accounting Standard No. 106, "Employer's Accounting for Post Retirement Benefits Other than Pensions" ("SFAS No. 106"). As of December 31, 2002 and 2001, the accumulated severance pay in that regard amounted to $1,630,366 and $1,975,535, respectively.

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

Severance income for the year ended December 31, 2002 amounted to $338,574 as compared to severance expenses for the years ended December 31, 2001 and 2000, which amounted to $653,885 and $430,943, respectively.

s. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2002, 2001

and 2000 was approximately $294,599, $1,676,280 and $1,453,025, respectively.

t. Impact of recently issued accounting standards:

In June 2002, the FASB issued SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" which addresses significant issues regarding the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on its results of operations or financial position.

NOTE 3:– RESTRICTED COLLATERAL DEPOSIT AND OTHER RESTRICTED CASH

The restricted collateral deposit is invested in a $595,341 certificate of deposit that is used to secure a standby letter of credit required in connection with a sales contract the Company signed with the Royal Thai Army on September 28, 2002. The other restricted cash consists of security deposits in connection with real property lease arrangements.

NOTE 4:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2002	2001
	U.S. dollars	
Government authorities	$ 348,660	$ 204,435
Employees	23,959	4,680
Prepaid expenses	591,008	198,150
Other	68,684	41,386
	$ 1,032,311	$ 448,651
	$ 348,660	$ 204,435

NOTE 5:– INVENTORIES

	December 31,	
	2002	2001
	U.S. dollars	
Raw and packaging materials	$ 893,666	$ 454,086
Work in progress	296,692	28,995
Finished products	521,121	40,285
	$ 1,711,479	$ 523,366

NOTE 6:– LOANS TO SHAREHOLDERS

In February and May 2000, two officers of the Company exercised options to purchase a total of 263,330 and 550,000, respectively, shares of the Company's common stock (see Note 12.e.2). In connection with such exercises, the Company granted loans secured by the Company's shares to those two officers to cover their related tax liabilities. The loans were in the form of non-recourse promissory notes in the total amount of $958,156, bearing interest at a rate equal to 4% over the then-current percentage increase in the Israeli Consumer Price Index ("CPI") between the date of the loan and the date of the annual interest calculation. During the years 2000 and 2001 one of the shareholders repaid a portion of his non-recourse note at the amount of $225,097 and $38,639, respectively. During the years 2002 and 2001, the Company has impaired those loans and has written off the amounts of $501,288 and $206,005, respectively, due to decline of the fair market value of its shares, which was recorded as compensation in general and administrative expenses.

NOTE 7:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2002	2001
	U.S. dollars	
Cost:		
Computers and related equipment	$ 815,759	$ 786,158
Motor vehicles	335,286	336,216
Office furniture and equipment	519,092	313,760
Machinery, equipment and installations	4,715,182	4,294,600
Leasehold improvements	442,482	355,536
	154,689	–
	6,982,490	6,086,270
Accumulated depreciation:		
Computers and related equipment	669,258	566,290
Motor vehicles	39,281	62,523
Office furniture and equipment	255,829	180,498
Machinery, equipment and installations	3,106,389	2,797,558
Leasehold improvements	356,484	258,595
	4,427,241	3,865,464
Depreciated cost	$ 2,555,249	$ 2,220,806

b. Depreciation expense amounted to $473,739, $530,013 and $514,242, for the years ended December 31, 2002, 2001 and 2000, respectively.

As for liens, see Note 11.d.

NOTE 8:– OTHER INTANGIBLE ASSETS, NET

a.

	December 31,	
	2002	2001
	U.S. dollars	
Intangible assets subject to amortization:		
Cost:		
Technology	$ 1,795,000	$ –
Existing contracts	46,000	–
Covenants not to compete	99,000	–
Customer list	812,000	–
	2,752,000	–
Less - accumulated amortization		
Technology	524,500	–
Existing contracts	23,000	–
Covenants not to compete	9,900	–
Customer list	66,143	–
	623,543	–
Amortized cost	2,128,457	–
Intangible assets not subject to amortization:		
Trademarks	439,000	–
	$ 2,567,457	$ –

b. Amortization expenses amounted to $623,543 for the year ended December 31, 2002.

c. Weighted-average amortization period of the intangible assets is 4 years.

d. Estimated amortization expenses for the years ended:

Year ended December 31,	
2003	$ 1,172,000
2004	263,000
2005	233,000
2006	205,843
2007 and forward	254,614
	$ 2,128,457

NOTE 9:– PROMISSORY NOTES

In connection with the acquisition discussed in Note 1b, the Company issued promissory notes in the face amount of an aggregate of $1,800,000, one of which was a note for $400,000 that was convertible into an aggregate of 200,000 shares of the Company's common stock. The Company has accounted for these notes in accordance with Accounting Principles Board Opinion No. 21, "Interest on Receivables and Payables," and recorded the notes at its present value in the amount of $1,686,964. In December 2002, the terms of these promissory notes were amended to (i) extinguish the $1,000,000 note due at the end of June 2003 in exchange for prepayment of $750,000, (ii) amend the $400,000 note due at the end of December 2003 to be a $450,000 note, and (iii) amend the convertible $400,000 note due at the end of June 2004 to be a $450,000 note convertible at $0.75 as to $150,000, at $0.80 as to $150,000, and at $0.85 as to $150,000. In accordance with EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," the terms of the promissory notes are not changed or modified and the cash flow effect on a present value basis is less than 10% and therefore the Company did not record any compensation related to these changes.

NOTE 10:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2002	2001
	U.S. dollars	
Employees and payroll accruals	$ 615,292	$ 688,985
Accrued vacation pay	137,179	300,779
Accrued expenses	342,793	74,639
Advances from customers	–	98,070
Minority balance	289,451	–
Government authorities	497,428	–
Deferred warranty revenues	95,831	–
Other	31,135	60,180
	$ 2,009,109	$ 1,122,653

NOTE 11:– COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

1. Under EFL's research and development agreements with the Office of the Chief Scientist ("OCS"), and pursuant to applicable laws, EFL is required to pay royalties at the rate of 3%-3.5% of net sales of products developed with funds provided by the OCS, up to an amount equal to 100% of research and development grants received from the OCS (linked to the U.S. dollars. Amounts due in respect of projects approved after year 1999 also bear interest of the Libor rate).

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

Royalties paid or accrued for the years ended December 31, 2002, 2001 and 2000, to the OCS amounted to $32,801, $75,791 and $70,637, respectively.

As of December 31, 2002, total contingent liability to pay to OCS (at 100%) was outstanding at the amount of approximately $9,882,000.

2. EFL, in cooperation with a U.S. participant, has received approval from the BIRD-F for 50% funding of a project for the development of a hybrid propulsion system for transit buses. The maximum approved cost of the project is approximately $1.8 million, and the Company's share in the project costs is anticipated to amount to approximately $1.1 million, which will be reimbursed by BIRD-F at the aforementioned rate of 50%.

Royalties at rates of 2.5%-5% of sales are payable up to a maximum of 150% of the grant received, linked to the U.S. Consumer Price Index. Accelerated royalties are due under certain circumstances.

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

Royalties paid or accrued to the BIRD-F amounted at $0 for each of the three years ended December 31, 2002.

As of December 31, 2002, total contingent liability to pay BIRD-F (at 150%) was approximately $772,000.

b. Lease commitments:

The Company and its subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2005. The minimum rental payments under non-cancelable operating leases are as follows:

Year ended December 31,	
2003	$ 439,947
2004	147,444
2005	86,775
	$ 674,166

Total rent expenses for the years ended December 31, 2002, 2001 and 2000, were approximately $629,101, $456,701 and $261,000, respectively.

Rental payments are primarily payable in Israeli currency, linked to the Israeli Consumer Price Index ("CPI").

c. Guarantees:

The Company obtained bank guarantees in the amount of $34,893, mainly in respect of a letter of credit to the supplier of one of its subsidiaries.

d. Liens:

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

NOTE 12:– SHAREHOLDERS' EQUITY

a. Shareholders' rights:

The Company's shares confer upon the holders the right to receive notice to participate and vote in the general meetings of the Company and right to receive dividends, if and when declared.

b. Issuance of common stock to investors:

1. On January 5, 2000, the Company entered into a Common Stock Purchase Agreement with a group of private investors. Pursuant to this agreement, on January 10, 2000, the Company issued 385,000 shares of common stock to the investors for a total purchase price of $962,500.

2. On May 17, 2000, the Company entered into an agreement with an investor, pursuant to which the Company issued 1,000,000 shares of common stock to the investor, at a price of $10.00 per share, for a total purchase price of $10,000,000. In addition, on November 16, 2000, the Company subsequently issued an additional 92,952 shares of common stock pursuant to the anti-dilution calculation stated in the share purchase agreement with the investor.

3. On November 17, 2000, the Company entered into an agreement with a venture capital fund, pursuant to which the Company issued 1,000,000 shares of common stock to the investor, at a price of $8.375 per share, for a total purchase price of $8,375,000. (See also Note 12.f.2.)

4. In May 2001, the Company issued a total of 4,045,454 shares of its common stock to a group of institutional investors at a price of $2.75 per share, or a total purchase price of $11,125,000. (See also Note 12.f.2 and 12.f.3.)

5. On November 21, 2001, the Company issued a total of 1,503,759 shares of its common stock at a purchase price of $1.33 per share, or a total purchase price of $2,000,000, to a single institutional investor.

6. On December 5, 2001, the Company issued a total of 1,190,476 shares of its common stock at a purchase price of $1.68 per share, or a total purchase price of $2,000,000, to a single institutional investor.

7. On January 18, 2002, the Company issued a total of 441,176 shares of its common stock at a purchase price of $1.70 per share, or a total purchase price of $750,000, to an investor (see also Note 12.f.4).

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

c. Issuance of common stock to service providers and employees:

1. In June 2000, 35,000 shares of common stock were issued at par consideration to a consultant for providing business development and marketing services in the United Kingdom. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to $525,000 in accordance with EITF 96-18. In accordance with EITF 00-18, "Accounting Recognition for Certain Transactions Involving Equity Instruments

Granted to Other Than Employees" ("EITF 00-18"), the Company recorded this compensation expenses of $405,000 during the year 2000 and $120,000 during the year 2001 and included these amounts in marketing expenses.

2. On June 17, 2001 the Company issued a consultant a total of 8,550 shares of its common stock in compensation for services rendered by such consultant for the Company for preparation of certain video point-of-purchase and sales demonstration materials. At the issuance date the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to $15,488 in accordance with EITF 96-18. In accordance with EITF 00-18, the Company recorded this compensation expense as marketing expenses in the amount of $15,488.

3. On September 17, 2001 the Company issued to selling and marketing consultants a total of 337,571 shares of its common stock in compensation for distribution services rendered by such consultant. At the issuance date the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to $524,889 in accordance with EITF 96-18 and in accordance with EITF 00-18. The Company recorded this compensation expense as marketing expenses in the amount of $524,889.

4. On February 15, 2002 and September 10, 2002, 318,468 and 50,000 shares, respectively, of common stock were issued at par consideration to a consultant for providing business development and marketing services in the United Kingdom. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to $394,698 and $63,000, respectively, in accordance with EITF 96-18. In accordance with EITF 00-18, the Company recorded this compensation expense of $394,698 and $63,000, respectively, during the year 2002 and included this amount in marketing expenses.

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

d. Issuance of shares to lenders

As part of the securities purchase agreement on December 31, 2002 (see Note 17), the Company issued 387,301 shares at par consideration to lenders for the first nine months of interest expenses. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the interest and amounted to $236,250 in accordance with APB 14.

e. Issuance of notes receivable:

1. Non-recourse notes receivable from employee-shareholders arising from the purchase of 1,500,000 of the Company's shares, matured in 1998. The notes were renewed as recourse notes, due on December 31, 2007, bearing interest at a rate of 1% over the then-current federal funds rate of 5.5% or linked to the Israeli CPI, whichever is higher. In April 1998, the terms of the recourse notes were amended such that the Company would have recourse only to certain termination compensation due to the employee-shareholders (which exceeds the amounts outstanding under the notes), or if terminated for cause, the employee-shareholders would continue to be personally liable.

Additionally, the Company agreed to purchase the Company's shares from the employee-shareholders, at prevailing market prices, up to the full amount outstanding under the notes and to grant new options at exercise prices equal to prevailing market prices, in the amount that the shares were sold by the employee-shareholders.

In March 2000, the employee-shareholders exercised certain stock options (see Note 12.g). The proceeds in the amount of $605,052 from the sale of the shares were allocated to the repayment of the loan referred to above. As of December 31, 2002, there was no outstanding balance on this loan.

2. In February 2000 and in May 2000, certain officers of the Company exercised options to purchase a total of 263,330 and 550,000, respectively, shares of the Company's common stock, paying the exercise price in form of ten-year non-recourse promissory notes in an ag-

gregate amount of $658,326 and $3,040,250, respectively. The notes are secured by the shares issued upon exercise of such options, bearing non-recourse interest at a rate equal to the federal fund rate + 1%. (See Note 6)

The Company has accounted for these promissory notes as a variable stock award pursuant to the provisions of Emerging Issues Task Force issue 95-16, "Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion 25" ("EITF 95-16"). The Company did not record any compensation due to the decrease in the market value of the Company's shares during the years 2001 and 2000.

In February 2001, the Board of Directors of the Company, upon the recommendation of its Compensation Committee and with the agreement of the officers involved, purchased a total of 550,000 of the shares, which had already been issued, in exchange for repayment of the non-recourse notes from the officers in the amount of $3,470,431. $3,183,530 out of this amount relates to 550,000 shares from May 2000. The remaining amount of $248,262 represents repayment of other notes, including $38,639 of loans to shareholders described in Note 6. As a result of this transaction, the Company recorded treasury stock in the amount of $3,499,375. An amount of $228,674 was recorded as additional paid-in-capital as it reflected a compensation expense related to this re-purchase.

f. Warrants:

1. As part of an investment agreement in December 1999, the Company issued warrants to purchase up to an additional 950,000 and 475,000 shares of the Company's common stock to the investors at the exercise price of $1.25 and $4.50 per share, respectively. Pursuant to the terms of these warrants, a total of 251,196 shares of common stock were issued to such warrant holders in 2000 on a cashless exercise basis. As of December 31, 2000, 1,050,000 warrants had been exercised, in addition to the warrants issued on a cashless basis.

2. As part of the investment agreement in November 2000 (see Note 12.b.3), the Company issued warrants to purchase an additional 1,000,000 shares of common stock to the investor, with exercise prices of $11.31 for 333,333 of these warrants and $12.56 per share for 666,667 of these warrants. In addition, the Company issued warrants to purchase 150,000 shares of common stock, with exercise prices of $9.63 for 50,000 of these warrants and $12.56 per share for 100,000 of these warrants to an investment banker involved in this agreement. Out of these warrants issued to the investor, 666,667 warrants expire on November 17, 2005 and 333,333 warrants were to expire on August 17, 2001.

As part of the transaction in May 2001 (see Note 12 b.4), the Company repriced these warrants in the following manner:

- Of the 1,000,000 warrants granted to the investor, the exercise price of 666,667 warrants was reduced from $12.56 to $3.50 and of 333,333 warrants was reduced from $11.31 to $2.52. In addition, the 333,333 warrants that were to expire on August 17, 2001, were immediately exercised for a total consideration of $840,000.
- Moreover, the Company issued to this investor an additional warrant to purchase 250,000 shares of common stock at an exercise price of $3.08 per share, to expire on May 3, 2006.
- Of the 150,000 warrants granted to the investment banker the exercise price of 100,000 warrants was reduced from $12.56 to $3.08 and of 50,000 warrants was reduced from $9.63 to $3.08. In addition, the 50,000 warrants that were to expire on August 17, 2001 were extended to November 17, 2005.

As a result of the aforesaid modifications, including the repricing of the warrants to the investors and to the investment banker and the additional grant of warrants to the investor, the Company has recorded a deemed dividend in the amount of $1,196,667, to reflect the additional benefit created for these certain investors. The fair value of the repriced warrants was calculated as a difference measured between (1) the fair value of the modified warrant determined in accordance with the provisions of SFAS No. 123, and (2) the value of the old warrant immediately before its terms are modified, determined based on the shorter of (a) its remaining expected life or (b) the expected life of the modified option. The deemed dividend increased the loss applicable to common stockholders in the calculation of basic and diluted net loss per share for the year ended December 31, 2001, without any effect on total shareholder's equity.

3. As part of the investment agreement in May 2001 (see Note 12.b.4), the Company issued to the investors a total of 2,696,971 warrants to purchase shares of common stock at a price of $3.22 per share; these warrants are exercisable by the holder at any time after November 8, 2001 and will expire on May 8, 2006. The Company also issued to a financial consultant that provided investment banking services concurrently with this transaction a total of 125,000 warrants to purchase shares of common stock at a price of $3.22 per share; these warrants are exercisable by the holder at any time and will expire on June 12, 2006. In addition the Company paid approximately $562,000 in cash, which was recorded as deduction from additional paid in capital.

4. As part of the investment agreement in January 2002 (see Note 12.b.7), the Company, in January 2002, issued to a financial consultant that provided investment banking services concurrently with this transaction a warrants to acquire (i) 150,000 shares of common stock at an exercise price of $1.68 per share, and (ii) 119,000 shares of common stock at an exercise price of $2.25 per share; these warrants are exercisable by the holder at any time and will expire on January 4, 2007.

5. As part of the securities purchase agreement on December 31, 2002 (see Note 17), the Company issued to the purchasers of its 9% secured convertible debentures warrants as follows: (i) Series A Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.84 per share; (ii) Series B Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.89 per share; and (iii) Series C Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.93 per share.

In connection with these warrants, the Company will record financial expenses of $1,096,698, which will be amortized ratably over the life of the convertible debentures (3 years). This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("ETIF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 64%, dividend yields of 0% and a contractual life of 5 years.

g. Stock option plans:

1. Options to employees and others (except consultants)

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

1) 1991 Employee Option Plan – 2,115,600 shares reserved for issuance, of which 33,692 are available for future grants to employees as of December 31, 2002.

2) 1993 Employee Option Plan – as amended, 4,200,000 shares reserved for issuance, of which 1,904,781are available for future grants to employees as of December 31, 2002.

3) 1998 Employee Option Plan – as amended, 4,750,000 shares reserved for issuance, of which 2,070,460 are available for future grants to employees and consultants as of December 31, 2001.

4) 1995 Non-Employee Director Plan – 1,000,000 shares reserved for issuance, of which 640,000 are available for future grants to directors as of December 31, 2002.

b. Under these plans, options generally expire no later than 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).

c. A summary of the status of the Company's plans and other share options (except for options granted to consultants) granted as of December 31, 2002, 2001 and 2000, and changes during the years ended on those dates, is presented below:

	2002		2001		2000	
	Number	Weighted average exercise price	Number	Weighted average exercise price	Number	Weighted average exercise price
		$		$		$
Options outstanding at beginning of year	4,240,228	$ 2.74	2,624,225	$3.82	2,820,679	$ 3.44
Changes during year:						
Granted (1) (3)	1,634,567	$ 0.87	2,172,314	$1.55	1,598,233	$ 4.58
Exercised (4) (2)	(191,542)	$ 1.29	(159,965)	$1.31	(1,715,628)	$ 3.84
Forfeited or cancelled	(422,887)	$ 1.92	(396,346)	$4.11	(79,059)	$ 4.93
Repriced (2):						
Old exercise price	–	–	–	–	(310,000)	$ 4.95
New exercise price	–	–	–	–	310,000	$ 4.95
Options outstanding at end of year	5,260,366	$ 2.26	4,240,228	$2.74	2,624,225	$ 3.82
Options exercisable at end of year	4,675,443	$ 2.26	2,643,987	$2.75	1,078,332	$ 3.81

(1) Includes 481,435, 1,189,749 and 870,000 options granted to related parties in 2002, 2001 and 2000, respectively.

(2) On May 25, 2000, the Company repriced downwards 150,000 options from $6.60 per share to $4.95. The Company also repriced upward 160,000 options held by the same options holder from $3.375 per share to $4.95. The options holder immediately exercised those options. In accordance with FIN 44 the downward repricing resulted in a variable plan accounting, however, due to the immediate exercise the Company recorded a compensation expense in the amount of $26,250 at that date only.

(3) The Company recorded deferred stock compensation for options issued with an exercise price below the fair value of the common stock in the amount of $0, $18,000 and $37,924 as of December 31, 2002, 2001 and 2000, respectively. Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options to employees in 2002, 2001 and 2000, was $6,000, $17,240 and $20,684, respectively.

(4) In September 2002 and December 2001, the employees exercised 100,000 and 33,314, respectively, options for which the exercise price was not paid at the exercise date. The Company recorded the owed amount of $73,000 and $43,308, respectively, as "Note receivable from shareholders" in the statement of shareholders' equity. In accordance with EITF 95-16, since the original option grant did not permit the exercise of the options through loans, and due to the Company's history of granting non-recourse loans, this postponement in payments of the exercise price resulted in a variable plan accounting. However, the Company did not record any compensation due to the decrease in the market value of the Company's shares during 2001 and 2002. During the year 2002 the notes in the amount of $43,308 were entirely repaid and note at the amount of $36,500 was forgiven and appropriate compensation was recorded.

d. The options outstanding as of December 31, 2002 have been separated into ranges of exercise price, as follows:

	Total options outstanding			Exercisable options outstanding	
Range of exercise prices	Amount outstanding at December 31, 2002	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2002	Weighted average exercise price
$		Years	$		$
0.30-2.00	3,422,797	6.91	1.15	3,011,530	1.12
3.00-4.00	421,069	3.84	3.00	419,669	3.00
4.00-6.00	1,356,500	7.45	4.60	1,189,244	4.64
6.00-8.00	50,000	2.43	7.49	45,000	7.56
8.00	10,000	4.75	9.06	10,000	9.06
	5,260,366	6.75	2.26	4,675,443	2.26

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

	Equals market price			Exceeds market price			Less than market price		
	Year ended December 31,			Year ended December 31,			Year ended December 31,		
	2002	2001	2000	2002	2001	2000	2002	2001	2000
Weighted average exercise prices	$ 1.265	$ 1.579	$ 4.580	$ -	$ 1.466	$ 7.125	$ 0.755	$ 1.300	$ 5.270
Weighted average fair value on grant date	$ 0.560	$ 0.50	$ 4.120	$ -	$ 0.560	$ 3.760	$ 0.250	$ 0.790	$ 6.600

2. Options issued to consultants:

a. The Company's outstanding options to consultants as of December 31, 2002, are as follows:

	2002		2001		2000	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		$		$		$
Options outstanding at beginning of year	245,786	$ 5.55	175,786	$ 6.57	141,814	$ 3.09
Changes during year:						
Granted (1)	–	–	130,000	$ 6.02	198,500	$ 5.86
Exercised	–	–	(60,000)	$ 5.13	(164,528)	$ 2.72
Repriced (2):						
Old exercise price	–	–	(56,821)	$ 9.44	–	–
New exercise price	–	–	56,821	$ 4.78	–	–
Options outstanding at end of year	245,786	$ 5.55	245,786	$ 5.55	175,786	$ 6.56
Options exercisable at end of year	125,786	$ 6.42	125,786	$ 6.42	149,044	$ 6.80

(1) 120,000 options out of 130,000 options granted in 2001 to the Company's selling and marketing consultants are subject to the achievement of the targets specified in the agreements with these consultants. The measurement date for these options has not yet occurred, as these targets have not been met, in accordance with EITF 96-18. When the targets is achieved the Company will record appropriate compensation upon the fair value at the same date at which the targets is achieved.

(2) During the year 2001 the Company repriced 56,821 options to its service providers. The fair value of repriced warrants was calculated as a difference measured between (1) the fair value of the modified warrants determined in accordance with the provisions of SFAS 123, and (2) the value of the old warrant immediately before its terms were modified, determined based on the shorter of (a) its remaining expected life or (b) the expected life of the modified option. As a result of the repricing, the Company has recorded an additional compensation at the amount of $21,704, and included this amount in marketing expenses.

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

	2002	2001	2000
Dividend yield	–	0%	0%
Expected volatility	–	82%	95%
Risk-free interest	–	3.5-4.5%	6.5%
Expected life of up to	–	1 year	5 years

c. In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling $0, $139,291 and $796,128 for the years ended December 31, 2002, 2001 and 2000, respectively, and included these amounts in marketing expenses.

3. Dividends:

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

4. Treasury Stock:

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

NOTE 13:– INCOME TAXES

a. Taxation of U.S. parent company (EFC):

As of December 31, 2002, EFC has operating loss carryforwards for U.S. federal income tax purposes of approximately $15 million, which are available to offset future taxable income, if any, expiring in 2010-2015. Utilization of U.S net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating loses before utilization.

b. Israeli subsidiary (EFL):

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

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

The approved investment program is in the amount of approximately $500,000. EFL effectively operated the program during 1993, and is entitled to the tax benefits available under the Investments Law. EFL is entitled to additional tax benefits as a "foreign investment company," as defined by the Investments Law. In 1995, EFL received approval for a second "Approved Enterprise" program for investment in property and equipment, in the amount of approximately $6,000,000, and approval for grants at the abovementioned rates, for these approved property and equipment.

The entitlement to the above benefits is conditional upon the Company's fulfilling the conditions stipulated by the Investments Law, regulations published thereunder and the instruments of approval for the specific investments in "approved enterprises." In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2002, according to the Company's management, the Company has fulfilled all conditions.

The main tax benefits available to EFL are:

a) Reduced tax rates:

During the period of benefits (seven to ten years), commencing in the first year in which EFL earns taxable income from the "Approved Enterprise," a reduced corporate tax rate of between 10% and 25% (depending on the percentage of foreign ownership, based on present ownership percentages of 15%) will apply, instead of the regular tax rates.

The period of tax benefits, detailed above, is subject to limits of 12 years from the commencement of production, or 14 years from the approval date, whichever is earlier. Hence, the first program will expire in the year 2004 and the second in the year 2008. The commencement of production according to the third program has not been determined yet by the investment center and so there is no ability to determine the period of the tax benefits according to this program. The benefits have not yet been utilized since the Company has no taxable income, since its incorporation.

b) Accelerated depreciation:

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

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

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

ence between the reporting currency and the tax bases of assets and liabilities.

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

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

4. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 36%.

5. Tax rates applicable to income distributed as dividends by EFL:

The effective taxes on income distributed by EFL to its parent company, EFC, would increase as a result of the Israeli withholding tax imposed upon such dividend distributions. The overall effective tax rate on such distribution would be 28%, in respect of income arising from EFL's "Approved Enterprise," and 44% in respect of other income. EFL does not have any earnings available for distribution as dividend, nor does it intend to distribute any dividends in the foreseeable future.

6. Tax loss carryforwards:

As of December 31, 2002, EFL has operating loss carryforwards for Israeli tax purposes of approximately $93 million, which are available, indefinitely, to offset future taxable income.

c. European subsidiaries:

Income of the European subsidiaries, which is derived from intercompany transactions, is based on the tax laws in their countries of domicile.

d. Deferred income taxes:

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

	December 31,	
	2002	2001
	U.S. dollars	
Operating loss carryforward	$ 29,257,118	$ 12,162,581
Reserve and allowance	303,204	477,522
Net deferred tax asset before valuation allowance	29,560,322	12,640,103
Valuation allowance	(29,560,322)	(12,640,103)
	$ –	$ –

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2002 was $16,920,219.

e. Loss before taxes on income:

	Year ended December 31		
	2002	2001	2000
	U.S. dollars		
Domestic	$ (5,250,633)	$ (5,828,828)	$ (2,021,661)
Foreign	(13,254,195)	(11,457,960)	(9,959,297)
	$ (18,504,358)	$ (17,286,788)	$ (11,980,958)

NOTE 14:– SELECTED STATEMENTS OF OPERATIONS DATA

a. Research and development, net:

	Year ended December 31		
	2002	2001	2000
	U.S. dollars		
Research and development costs	$ 685,919	$ 455,845	$ 1,065,065
Less royalty-bearing grants	–	–	195,170
	$ 685,919	$ 455,845	$ 869,895

b. Financial income, net:

	Year ended December 31,		
	2002	2001	2000
	U.S. dollars		
Financial expenses:			
Interest, bank charges and fees	$ (89,271)	$ (49,246)	$ (67,480)
Foreign currency translation differences	15,202	(16,003)	(219,043)
	(74,069)	(65,249)	(286,523)
Financial income:			
Interest	174,520	327,830	830,704
Total	$ 100,451	$ 262,581	$ 544,181

NOTE 15:– RELATED PARTY DISCLOSURES

	Year ended December 31,		
	2002	2001	2000
	U.S. dollars		
Transactions:			
Reimbursement of general and administrative expenses	$ 36,000	$ 23,850	$ 28,880
Financial income (expenses), net from notes receivable and loan holders (see Notes 6 and 12.e.2)	$ (7,309)	$ (36,940)	$ 230,924

NOTE 16:– SEGMENT INFORMATION

a. General:

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

The Company previously managed its business in three reportable segments organized on the basis of differences in its related products and services. With the discontinuance of Consumer Batteries segment (see Note 1.e-Discontinued Operation) and acquiring two subsidiaries (see Notes 1.b.and c.), two reportable segments remain: Electric Fuel Batteries, and Defense and Security Products. As a result the Company reclassified information previously reported in order to comply with new segment reporting.

The Company's reportable operating segments have been determined in accordance with the Company's internal management structure, which is organized based on operating activities. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based upon two primary factors, one is the segment's operating income and the other is based on the segment's contribution to the Company's future strategic growth.

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

	Electric Fuel Batteries	Defense and Security Products	All Other	Total
2002				
Revenues from outside customers	1,662,296	$ 4,724,443	$ -	$ 6,406,739
Depreciation expense and amortization	(252,514)	(676,753)	(194,013)	(1,123,280)
Direct expenses (1)	(3,062,548)	(4,353,770)	(2,905,743)	(10,322,061)
Segment gross loss	$ (1,652,766)	$ (306,080)	$ (3,099,756)	(5,038,602)
Financial income				100,451
Net loss from continuing operation				$ 4,938,151
Segment assets (2)	$ 2,007,291	$ 1,683,825	$ 575,612	$ 4,266,728
Expenditures for segment assets	$ 246,664	$ 58,954	$ 70,486	$ 376,104
2001				
Revenues from outside customers	$ 2,093,632	$ -	$ –	$2,093,632
Depreciation expense	(304,438)	-	(225,575)	(530,013)
Direct expenses (1)	(2,295,501)	-	(3,556,486)	(5,851,987)
Segment gross loss	$ (506,307)	$ -	$ (3,782,061)	(4,288,368)
Financial income net				262,581
Net loss from continuing operations				$ (4,025,787)
Segment assets (2)	$ 2,044,257	$ 1,175,521	$ 702,915	$ 2,744,172
Expenditures for segment assets	$ 229,099	$ 229,099	$ 323,985	$ 553,084
2000				
Revenues from outside customers	$ 1,478,495	$ -	$ 11,446	$1,489,941
Depreciation expense	(310,408)	-	(203,834)	(514,242)
Direct expenses (1)	(1,754,003)	-	(3,150,558)	(4,904,561)
Segment gross loss	$ (585,916)	$ -	$ (3,342,946)	(3,928,862)
Financial income net				544,181
Net loss from continuing operations				$ (3,384,681)
Segment assets (2)	$ 2,020,771	$ -	$ 662,575	$ 2,683,346
Expenditures for segment assets	$ 284,939	$ 284,939	$ 310,988	$ 595,927

(1) Including sales and marketing, general and administrative expenses.

(2) Including property and equipment and inventory.

c. Summary information about geographic areas:

	2002		2001		2000	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars					
U.S.A.	$ 2,787,250	$ 6,710,367	$ 1,057,939	$ 60,531	$ 813,658	$ 26,412
Germany	38,160	–	526,766	–	44,117	–
England	47,696	–	36,648	–	30,885	–
Thailand	291,200	–	–	–	–	–
Israel	2,799,365	3,367,320	13,773	2,160,275	19,279	2,262,465
Other	443,068	–	458,506	–	582,003	–
	$ 6,406,739	$10,077,687	$ 2,093,632	$ 2,220,806	$ 1,489,942	$ 2,288,877

* Reclassified

d. Revenues from major customers:

	Year ended December 31,		
	2002	2001	2000
		%	
Electric Fuel Batteries:			
Customer A	–	22%	–
Customer B	7%	20%	17%
Customer C	2%	13%	20%
Customer D	8%	12%	–
Defense and Security: Products	43%	–	–

e. Revenues from major products:

Major Product	Segment	Year ended December 31, 2002	2001	2000
EV	Electric Fuel Batteries	$ 460,562	$ 894,045	$ 310,441
WAB	Electric Fuel Batteries	647,896	951,598	1,168,055
Security and defense	Electric Fuel Batteries	573,838	247,989	–
Total Electric Fuel Batteries		1,662,296	2,093,632	1,478,495
Car armoring	Defense and Security Products	2,744,382	–	–
Interactive use-of-force training	Defense and Security Products	1,980,061	–	–
Total Defense and Security		4,724,443	–	–
Other	Other	–	–	11,446
Total		$ 6,406,749	$ 2,093,632	$ 1,489,942

NOTE 17:– CONVERTIBLE DEBENTURES

Pursuant to the terms of a Securities Purchase Agreement dated December 31, 2002, the Company issued and sold to a group of institutional investors an aggregate principal amount of 9% secured convertible debentures in the amount of $3.5 million due June 30, 2005. These debentures are convertible at any time prior to June 30, 2005 at a conversion price of $0.75 per share, or a maximum aggregate of 4,666,667 shares of common stock (see also Note 12.f.5).

In determining whether the convertible debentures include a beneficial conversion option in accordance with EITF 98-5 “Accounting for Convertible Securities with Beneficial Conversion Features or Continently Adjustable Conversion Ratios” and EITF 00-27, the total proceeds were allocated to the convertible debentures and the detachable warrants based on their related fair values. In connection with these convertible debentures, the Company will record financial expenses of $585,365. The $585,365 will be accreted from the date of issuance to the stated redemption date – June 30, 2005 – as financial expenses.

NOTE 18:– PROFIT DISTRIBUTION

On September 30, 2002, MDT distributed in cash to its shareholders profit in the amount of NIS 4,000,000 (approximately $841,288), out of which $412,231 was paid to the minority interest.

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AROTECH OFFICERS AND DIRECTORS

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

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

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

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

Jack E. Rosenfeld, Director
President and Chief Executive Officer, Potpourri Collection Inc.

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

Avihai Shen
Vice President – Finance and Chief Financial Officer of Arotech

Yaakov Har-Oz
Vice President, General Counsel and Secretary of Arotech

Electric Fuel Battery Corporation
Steven Esses, *President*

IES Interactive Training Inc.
Greg Otte, *President*

MDT Protective Industries Ltd.
Joseph Bar, *President*

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Monday, September 15, 2003, at 10:00 a.m. local time in the Ballroom of the Shelburne Murray Hill Hotel, 303 Lexington Avenue, New York, New York.

Stock Transfer Agent

American Stock Transfer & Trust Company, 40 Wall Street, New York, New York 10005.

Shares Traded

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

Independent Auditor

Kost Forer & Gabbay, a member firm of Ernst & Young Global, 3 Aminadav Street, Tel-Aviv, Israel.

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, 612 Broadway, Suite 1200, New York, New York 10012.

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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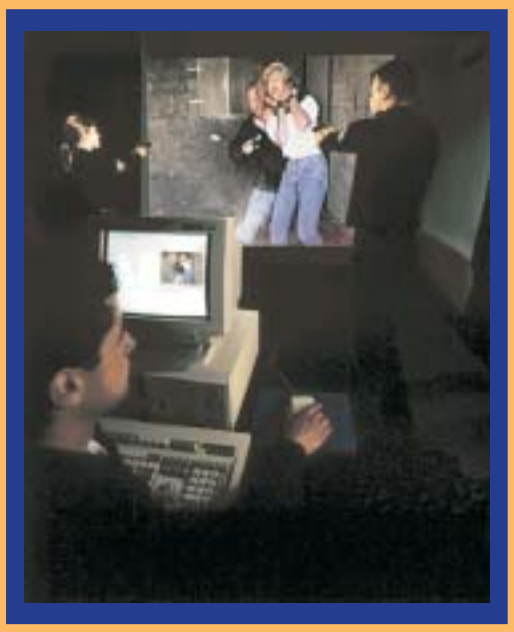

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