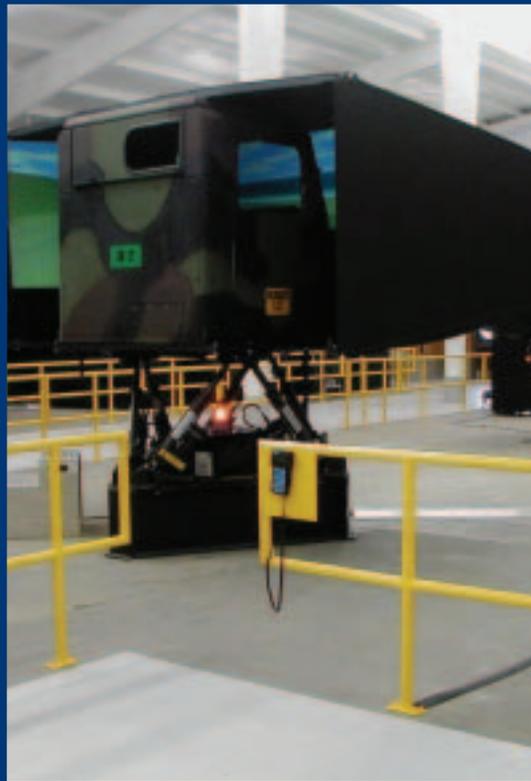


ANNUAL REPORT 2003



Leading Products and Services for the Military and Security Markets

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AROTECH

BATTERY & POWER SYSTEMS

SIMULATION, TRAINING & CONSULTING

ARMORED VEHICLES



ANNUAL REPORT 2003

Leading Products and Services for the Military and Security Markets
Battery and Power Systems Simulation, Training and Consulting
Vehicle Armoring
Security Markets
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Battery
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Vehicle

AROTECH

The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on March 30, 2004.

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.*

May 2004

Dear Fellow Shareholder,

In 2003 we made significant progress in transforming Arotech into a growing defense and homeland security company – and in maximizing value for Arotech’s shareholders.

When we changed our name from Electric Fuel to Arotech in the beginning of 2003, we intended more than just a name change. We wanted to demonstrate in a tangible way our intent to make a strategic shift away from our unsuccessful consumer battery business into the growing market of defense and homeland security products and services.

Our first steps involved taking our core Zinc-Air battery technology and applying it to military applications, while simultaneously broadening our military and defense focus by building IES Interactive Training and MDT Protective Industries, both of which we had acquired in the third quarter of 2002.

- Our military battery plant in Auburn, Alabama began shipping our new BA-8180 Zinc-Air batteries to the U.S. Army in March 2003. During 2003 we delivered over 16,000 batteries – worth more than \$4.6 million – to the U.S. Army. Many of these batteries were sent directly to Iraq, to support Coalition forces.
- IES Interactive Training had a record year in 2003, beginning with a \$2.6 million order from the federal police in Germany, and continuing with orders from NASA, the Veterans Administration Hospitals, the FBI, the Department of Health and Human Services, certain nuclear power stations and a variety of police departments and police academies nationwide. IES also introduced its Range FDU product in 2003 – a unique firearms diagnostic unit that gives instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.
- MDT, our vehicle armoring business, saw its business slip during 2003, due to financial constraints of its main customer, the Israel Defense Forces. Nevertheless, orders received in the third quarter from Coalition participants in Iraq picked up some of the shortfall, and we have already seen a substantial increase in orders for armored vehicles during the beginning of 2004. Currently MDT is seeing a substantial growth in orders and prospects from Iraq and expects significantly higher revenues in 2004. In anticipation of the need to grow beyond Israel, MDT began U.S. operations in Auburn, Alabama in late 2003 and won its first GSA contract and U.S. State Department approval before the end of 2003 – faster than we could have hoped.

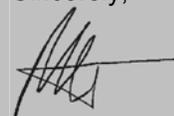
We began 2004 with two new significant acquisitions, both with experienced management in place: Epsilor Electronic Industries Ltd. and FAAC Incorporated. These acquisitions are an important part of our program to continue to build the company in revenue and profits.

The acquisition of Epsilor, an Israeli-based lithium battery and charger company with customers in Europe, Asia and Israel, will substantially increase both our battery revenues and our product offerings for the military. FAAC, based in Ann Arbor, Michigan, is a leading provider of driving simulators, high fidelity analytic models and simulators of tactical air and land warfare and onboard software to support launch weapon decisions for the F-15, the F-18 and the Joint Strike Fighter new aircraft. We believe that FAAC and IES, working together, will provide us with a truly synergistic simulation and training division.

We are confident that the steps we took in 2003 and in 2004 and the underlying strength of our new business model and the new businesses we have acquired, will continue to have a substantial and positive impact on shareholder value.

Thank you all for your continued confidence and support

Sincerely,



Robert S. Ehrlich
Chairman, President and CEO

General

We are a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate primarily as a holding company, through our various subsidiaries, which are organized into three divisions. Our divisions and subsidiaries are as follows:

➤ We develop, manufacture and market advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement and security personnel, as well as offering security consulting and other services (our ***Simulation, Training and Consulting Division***), consisting of:

- IES Interactive Training, Inc., located in Littleton, Colorado, which provides specialized “use of force” training for police, security personnel and the military (“IES”);
- FAAC Incorporated, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (“FAAC”); and
- Arocon Security Corporation, located in New York, New York, which provides security consulting and other services, focusing on protecting life, assets and operations with minimum hindrance to personal freedom and daily activities (“Arocon”).

➤ We manufacture and sell Zinc-Air and lithium batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles (our ***Battery and Power Systems Division***), consisting of:

- Electric Fuel Battery Corporation, located in Auburn, Alabama, which manufactures and sells Zinc-Air fuel cells, batteries and chargers for the military, focusing on applications

that demand high energy and light weight (“EFB”);

- Epsilon Electronic Industries, Ltd., located in Dimona, Israel (in Israel’s Negev desert area), which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia (“Epsilon”); and
- Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel, which produces water-activated lifejacket lights for commercial aviation and marine applications, and which conducts our Electric Vehicle effort, focusing on obtaining and implementing demonstration projects in the U.S. and Europe, and on building broad industry partnerships that can lead to eventual commercialization of our Zinc-Air energy system for electric vehicles (“EFL”).

➤ We utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our ***Armored Vehicle Division***), consisting of:

- MDT Protective Industries, Ltd., located in Lod, Israel, which specialize in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and cars, and is a leading supplier to the Israeli military, Israeli special forces and special services (“MDT”), of which we own 75.5%; and
- MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT’s United States activities (“MDT Armor”), of which we own 88%.

We acquired FAAC and Epsilon in early 2004. Prior to the acquisition of FAAC and Epsilon, we were organized into two divisions: Defense and Security Products (consisting of IES, MDT, MDT Armor and Arocon), and Electric Fuel Batteries (consisting of EFL and EFB). We have reported our results of operations for 2003 and 2002 in accordance with these earlier divisions, and our financial results for 2003 and 2002 do not include the activities of FAAC or Epsilon.

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, under the name "Electric Fuel Corporation"; we changed our name to Arotech Corporation in September 2003. 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 in 2002 and 2003 of a total of \$9.3 million in 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 IES and MDT. In the first quarter of 2004, we added two new subsidiaries, with their business lines, to our company: FAAC and Epsilon.

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 under the name "Electric Fuel Corporation," and we changed our name to "Arotech Corporation" on September 17, 2003. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech's wholly-owned Israeli subsidiaries, EFL and Epsilon; its majority-owned Israeli subsidiaries, MDT and MDT Armor; and its wholly-owned United States subsidiaries, EFB, IES, Arocon and FAAC.

For financial information concerning the business segments in which we operate, see Note 15 of the Notes to the Consolidated Financial Statements. For financial information about geographic areas in which we engage in busi-

ness, see Note 15.c of the Notes to the Consolidated Financial Statements.

Simulation, Training and Consulting Division

Use-of-Force Training

Through our wholly-owned subsidiary, IES Interactive Training, Inc., we provide specialized "use of force" training for police, 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 world's leading training academies and law enforcement agencies, including (in the United States) the FBI, the Secret Service, the Bureau of Alcohol, Tobacco and Firearms, the Customs Service, the Federal Protective Service, the Border Patrol, the Bureau of Engraving and Printing, the Coast Guard, the Federal Law Enforcement Training Centers, the Department of Health and Human Services, the California Department of Corrections, NASA, police departments in Texas (Houston), Michigan (Detroit), D.C., California (Fresno and the California Highway Patrol), Massachusetts (Brookline), Virginia (Newport News and the State Police Academy), Arizona (Maricopa County), universities and nuclear power plants, as well as 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 500 other training departments worldwide.

Our interactive training systems vary 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 Simulators

Through our wholly-owned subsidiary, FAAC Corporation, we provide simulators, systems engineering and software products to the United States military, government and private industry. FAAC's fully interactive driver-training systems feature state-of-the-art vehicle simulator technology enabling training in situation awareness, risk analysis and decision making, emergency reaction and avoidance procedures, and conscientious equipment operation. FAAC has an installed base of 179 simulators that have successfully trained over 80,000 drivers. FAAC's customer base includes all branches of the Department of Defense, state and local governments, and commercial entities.

We believe that FAAC is the premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare for all branches of the Department of Defense and its related industrial contractors. Simulations developed by FAAC are found in systems ranging from instrumented air combat and maneuver ranges (such as Top Gun) to full task training devices such as the F-18 Weapon Tactics Trainer.

FAAC supplies on-board software to support weapon launch decisions for the F-15, F-18, and Joint Strike Fighter fighter aircraft. Pilots benefit by having highly accurate presentations of their weapon's capabilities, including susceptibility to target defensive reactions. FAAC designed and developed an Instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system. The special operational forces aircrew training system provides a full range of aircrew training, including initial qualification, mission qualification, continuation, and upgrade training, as well as combat mission rehearsal.

Security Consulting

Arocon Security Corporation focuses on protecting life, assets and operations with minimum hindrance to personal freedom and daily activities. Arocon Security, which provides security consulting and other services, has signed an agreement with Rafael Armament Development Authority Ltd., Israel's leading defense research and development company, to market and implement certain of Rafael's security products and technology in the United States.

Battery and Power Systems Division

Zinc-Air Fuel Cells, Batteries and Chargers for the Military

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 Zinc-Air 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.

Our primary existing battery product for the military and defense sectors is a 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, weighs only six pounds and has approximately twice the energy capacity per pound of the U.S. Army's standard lithium-sulfur dioxide battery packs – the BA-8180/U battery, which offer extended-use portable power using our commercial Zinc-Air cell technology. Our BA-8180/U battery has received a National Stock Number (a Department of Defense catalog number assigned to products authorized for use by the U.S. military), making our batteries available for purchase by all units of the U.S. Armed Forces.

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.

Lithium Batteries and Charging Systems for the Military

Recent developments and improvements in lithium rechargeable batteries have caused the US military, as well as armies worldwide, to shift many battery-operated devices to cost-effective rechargeable batteries. Non-rechargeable batteries continue to be the leading source of energy in war and during limited conflicts. For more than ten years, our wholly-owned subsidiary Epsilon Electronic Industries, Ltd. has developed and sold rechargeable and primary lithium batteries and smart chargers to the military, and to private industry in the Middle East, Europe and Asia.

Electric Vehicle

Our electric vehicle effort, conducted through our subsidiary Electric Fuel Battery Corporation, continues to focus on finding a strategic partner that can lead the way to eventual commercialization of the Zinc-Air energy system. Our all-electric bus, powered by our Zinc-Air fuel cell technology, has demonstrated a world-record 127-mile range under rigorous urban conditions.

Lifejacket Lights

We produce water-activated lifejacket lights for commercial aviation and marine applications based on our patented water-activated magnesium-cuprous chloride battery technology. We intend to continue to work with original equipment manufacturers (OEMs), distributors and end-user companies to expand our market share in the aviation and marine segments. We presently sell five products in the safety products group, three for use with marine life jackets and two for use with aviation life vests. All five products are certified under applicable international marine and aviation safety regulations.

Armored Vehicles Division

Through our majority-owned MDT Protective Industries Ltd. and MDT Armor Corporation subsidiaries, 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.

Facilities

Our principal executive offices are located at 250 West 57th Street, Suite 310, New York, New York 10107, and our telephone number at our executive offices is (212) 258-3222. 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 made available through hyperlinks located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>, as soon as reasonably practicable after such material is electronically filed with or furnished to the

SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this annual report.

The offices and facilities of our three of our principal subsidiaries, EFL, MDT and Epsilon, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of our senior management is located at EFL's facilities. IES's offices and facilities are located in Littleton, Colorado, FAAC's offices and facilities are located in Ann Arbor, Michigan, and the offices and facilities of EFB and MDT Armor are located in Auburn, Alabama.

Simulation, Training and Consulting Division

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, security, military and similar applications. With a customer base of over 500 customers in over twenty 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 35% 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 judgment training simulator in the world.
- *A2Z Classroom Trainer* – a state-of-the-art computer based training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom.
- *Range FDU (Firearms Diagnostic Unit)* – a unique combination of training and interactive technologies that give instructors a first-person perspective of what trainees

are seeing and doing when firing a weapon.

- *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.

IES's revenues during 2001, 2002 and 2003 were approximately \$3.5 million, \$5.1 million and \$8.0 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 control tactics with the use of additional equipment such as take-down dummies can be used.
- *Firearms Training and Basic Marksmanship* – Either utilizing laser based training weapons or in conjunction with a live-fire screen, the use of "Live Ammunition" training can be employed on the system.

The interactive training scenarios are projected either through single or multiple screens and projectors, allowing 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 customized interactive courses and scenarios.

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

menu and mouse operation make the A2Z user-friendly.

The individual keypads are connected “wirelessly.” The system is completely portable and may be setup within a matter of minutes.

Key advantages:

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

Range FDU

The Range FDU (firearm diagnostics unit) is a unique combination of training and interactive technologies that give instructors a first-person perspective of what trainees are seeing and doing when firing a weapon. The Range FDU is the only firearms training technology of its kind.

With the Range FDU, firearms instructors can see the trainees’ actual sight alignment to the target as well as measure trigger pressure against proper trigger pressure graphs, making corrective instruction simple and effective. In addition, the Range FDU records a trainee’s recoil control, grip and stance – allowing the instructor to playback the information in slow motion or real time to better analyze the trainee’s actions and more accurately diagnose any deficiencies.

The Range FDU also has the ability to record the firearm instruction session to either DVD or VHS, allowing both the trainee and the instructor to review it at a later time. Trainees now have a diagnostic tool that they can learn from, even after their training has been com-

pleted. In addition, instructors can build a library for each trainee to record progress.

The Range FDU provides the following benefits:

- Fall of shot feedback
- Trigger pressure analysis
- Recoil control, grip and stance assessment
- Sight alignment
- Sight picture analysis and target reacquisition

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's interactive systems. Courses are designed to address specific department issues, and can be customized to fit each agency's needs. These courses are available in boxed sets that provide the customer with a turn-key training session. The A2Z Classroom Trainer and the Range 3000 XP-4 are used to deliver the curriculum and create a virtual world that the trainees respond and react to. Strategic relationships with high profile companies such as H&K Firearms, and Taser International, provide customers with training that deals with cutting edge issues facing law enforcement today. The incorporation of 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, provides 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 Simulators

Through our wholly-owned subsidiary, FAAC Corporation, we provide simulators, systems engineering and software products to the United States military, government and private industry. FAAC's fully interactive driver-training systems feature state-of-the-art vehicle simulator technology enabling training in situation awareness, risk analysis and decision making, emergency reaction and avoidance procedures, and conscientious equipment operation. FAAC has an installed base of over 179 simulators that have successfully trained over 80,000 drivers. FAAC's customer base includes all branches of the U.S. Department of Defense, state and local governments, and commercial entities.

INTRODUCTION

Based in Ann Arbor, Michigan, FAAC is a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare for all branches of the Department of Defense and its related industrial contractors. Simulations developed by FAAC are found in

systems ranging from instrumented air combat and maneuver ranges (such as Top Gun) to full task training devices such as the F-18 Weapon Tactics Trainer. FAAC is also the leading supplier of wheeled vehicle simulators to the U.S. Armed Forces for mission-critical vehicle training. Management believes that FAAC has held a 100% market share in U.S. military wheeled simulators since 1999 and holds a market share in excess of 50% in commercial wheeled vehicle simulators.

Simulators are cost-effective solutions, enabling users to reduce overall aircraft and ground vehicle usage, vehicle maintenance costs, fuel costs, repairs, and spares expenditures. For example, FAAC's Medium Tactical Vehicle Replacement (MTVR) simulators have reduced total driver training time by 35%. Many customers have reduced actual "behind-the-wheel" time by up to 50% while still maintaining or improving safety. Additionally, for customers with multiple simulators, the corresponding increase in the student to instructor ratio has reduced instructor cost per student.

The implementation of FAAC simulators has led to measurable benefits. North American Van Lines, one of FAAC's earliest vehicle simulator customers, has shown a 22% reduction in preventable accidents since it began using FAAC's simulators. The German Army, one of FAAC's earliest Military Vehicle customers, showed better driver testing scores in 14 of 18 driver skills compared to classroom and live driver training results. Additionally, the New York City Transit Authority documented a 43% reduction in preventable accidents over its first six months of use and has reduced its driver hiring and training "washout" by 50%.

Simulators can produce more drastic situations than can traditional training, which inherently produces drivers that are more skilled in diverse driving conditions. For example, while many first-time drivers will learn to drive during the summer months, they are not trained to drive in wintry conditions. Simulators can produce these and other situations, such as a tire blow-out or having to react to a driver cutting off the trainee, effectively preparing the driver for adverse conditions.

FAAC supplies on-board software to support weapon launch decisions for the F-15, F-18, and Joint Strike Fighter fighter aircraft. Pilots benefit by having highly accurate presentations of their weapon's capabilities, including susceptibility to

target defensive reactions. FAAC designed and developed an Instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system. The special operational forces aircrew training system provides a full range of aircrew training, including initial qualification, mission qualification, continuation, and upgrade training, as well as combat mission rehearsal.

FAAC operates in two primary business areas: Vehicle Simulations, which focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles – for commercial, governmental and foreign customers; and Military Operations, which conducts tactical air and land combat analysis and develops analytical models, simulations, and “turnkey” training systems for the U.S. military. In 2003, Vehicle Simulations accounted for approximately 75% of FAAC’s revenues, and Military Operations accounted for approximately 25% of FAAC’s revenues.

FAAC’s revenues during 2001, 2002 and 2003 were approximately \$12.2 million, \$15.2 million and \$9.8 million, respectively.

PRODUCT LINES

Below is a description of FAAC’s products and product lines.

Vehicle Simulations

Military Vehicles

Military Vehicles is FAAC’s largest business segment. Military vehicle simulators are highly realistic vehicle simulators that include variable reactive traffic and road conditions, the capacity to customize driving conditions to be geography-specific, and training in hazardous and emergency conditions. FAAC has several large contracts and task orders in the Military Vehicles business, including (i) the MTRV contract to develop vehicle simulators and related training services for the U.S. Marine Corps; (ii) a series of scheduled General Services Administration purchases of simulators with the U.S. Army to supply 78 simulators for 25 training sites; and (iii) a two-year contract with the U.S. Navy Seabees to supply eight simulators for three training sites. Management estimates that FAAC’s software trained 9,000 soldiers at four sites in 2002.

FAAC’s military vehicle simulators provide complete training capabilities based on integrated, effective simulation solutions to military vehicle operators in the U.S. Armed Forces. FAAC’s flagship military vehicle simulation product is its MTRV Operator Driver Simulator, developed for the USMC. The MTRV ODS concept is centered on a pod of up to six Student Training Stations (STS) and a single controlling Instructor Operator Station (IOS). The STS realistically simulates the form, fit, and feel of the MTRV vehicle. The high-fidelity version of the STS consists of a modified production cab unit mounted on a full six-degree-of-freedom motion platform. The STS provides over an 180-degree field of view into a realistically depicted virtual world, simulating a variety of on-road and off-road conditions. The IOS is the main simulation control point supporting the instructor’s role in simulator training. The IOS initializes and configures the attached STS, conducts training scenarios, assesses student performance, and maintains scenarios and approved curriculum.

FAAC’s software solution provides a complete operator training curriculum based upon integrated simulation training. Military vehicle simulators enable students to learn proper operational techniques under all terrain, weather, road, and traffic conditions. Instructors can use simulators as the primary instructional device, quantitatively evaluating student performance under controlled, repeatable scenarios. This monitoring, combined with the ability to create hazardous and potentially dangerous situations without risk to man or material, results in well-trained students at significantly less cost than through the use of traditional training techniques. In addition to standard on-road driver training, FAAC’s military vehicle simulators can provide training in such tasks as:

- Off-road driving on severe slopes, including muddy or swampy terrain;
- Night vision goggle and blackout conditions;
- Convoy training; and
- The use of the Central Tire Inflation System in response to changing terrain.

In addition to simulation systems, FAAC offers on-site operator and maintenance staff, train-the-trainer courses, curriculum development, scenario development, system mainten-

ance, software upgrades, and warranty packages to its U.S. Armed Forces customers.

Commercial Vehicles

Commercial Vehicles is FAAC's second largest business segment. The Commercial Vehicles business is comprised of technology similar to that of the Military Vehicles product line and also is customized to reflect the specific vehicle being simulated. FAAC serves four primary customer bases in the Commercial Vehicles business: transit, municipal, airport, and corporate customers.

Transit

Transit customers represent an attractive customer base as they generally have access to their own funds, which often exempts them from the lengthy and complex process of requesting funds from a governing body. FAAC has provided simulators to ten leading transit authorities, including the New York City Transit Authority, Washington, D.C. Metro, and Dallas Area Rapid Transit.

Municipal

FAAC targets municipal customers in police departments, hospitals, fire departments, and departments of transportation for sales of its municipal product. FAAC's customers include the Mexico Department of Education, California Department of Transportation, and the Fire Department of New York. FAAC is developing an industry advisory group focusing on the municipal market to identify and address customer needs. Additionally, FAAC has developed a simulator module to extend the simulation once police, fire, or emergency medical service personnel reach the incident location. FAAC management believes that this represents another of FAAC's bases of differentiation over its competition.

Airport

FAAC was a pioneer in providing simulation software to airports to facilitate training personnel in adverse conditions, including the Detroit and Toronto airports.

Corporate

FAAC targets corporate fleets and "for-hire" haulers as customers of the corporate simulator product. These customers use simulators to train personnel effectively as well as to avoid the brand damage that could be associated with poor driver performance. To date, FAAC has provided simulators to customers such as

Schlumberger Oil Services, Kramer Entertainment, and North American Van Lines.

Military Operations

FAAC provides air combat range software, missile launch envelope decision support software, the SimBuilder™ simulation software product, and Weapon System Trainer software through the Military Operations business line.

Air Combat Range Software

FAAC serves the U.S. Air Force Air Combat Training System and U.S. Navy Tactical Aircrew Training System with its air combat training range software. Air combat training ranges allow pilots to train and evaluate new tactics in a controlled airborne environment. Air "battles" are extremely realistic, with FAAC software determining the outcome of weapon engagements based on launch conditions and the target aircraft defensive reactions.

Missile Launch Envelope Software

Onboard weapon decision-making software enables pilots to assimilate the complex information presented to them in F-15 and F-18 fighter aircraft. FAAC provides its missile launch envelope software to the U.S. Navy and Air Force through its subcontracting relationships with Boeing.

Weapon System Trainer Software

FAAC has successfully transitioned software from U.S. Navy Tactical Aircrew Training Systems to over 15 Weapon Systems Trainers built by prime contractors such as L-3, Boeing, Northrop Grumman, and Lockheed Martin.

SIMBuilder™

The SimBuilder™ simulation software product is designed to provide weapons simulation models for use in training environments for launched weapons. This software enables foreign end-users to use weapons simulation models similar to the U.S. military without classified U.S. weapons data. Militaries of Canada, Taiwan, and Singapore currently use SimBuilders™.

Security Consulting

Arocon Security Corporation focuses on protecting life, assets and operations with minimum hindrance to personal freedom and daily activities. Arocon Security, which provides security consulting and other services, has signed an agreement with Rafael Armament Development Authority Ltd., Israel's leading defense research

and development company, to market and implement certain of Rafael's security products and technology in the United States.

Battery and Power Systems Division

Zinc-Air Fuel Cells, Batteries and Chargers for the Military

We base our strategy in the field of Zinc-Air 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 CECOM to develop and evaluate advanced primary Zinc-Air fuel cell packs. Pursuant to these contracts, we developed and began selling in 2002 a 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, weighs only six pounds and has approximately twice the energy capacity per pound of the U.S. Army's standard lithium-sulfur dioxide battery packs – the BA-8180/U battery.

In the second half of 2002, our five-year program with CECOM to develop a Zinc-Air battery for battlefield power culminated in the assignment of a National Stock Number and a \$2.5 million delivery order for the newly designated BA-8180/U battery. Subsequent to this initial \$2.5 million delivery order, we received in 2003 an additional \$6.8 million in follow-on orders from the Army.

Our batteries have been used in both Afghanistan (Operation Enduring Freedom) and in Iraq (Operation Iraqi Freedom). The significant contribution that our batteries made to both these endeavors was recognized by General Tommy R. Franks, then the Commander of United States Central Command (USCENTCOM), who said in a letter to EFB dated July 3, 2003, "Your efforts in managing and supplying zinc-air batteries were seen as nothing less than spectacular. The long hours, hard work, and personal sacrifices made in support of these operations have ensured our War Fighters had the

necessary resources to successfully conduct their missions without interruption."

Our Zinc-Air fuel cells, batteries and chargers for the military are manufactured through our Electric Fuel Battery Corporation subsidiary. In 2003, EFB's facilities were granted ISO 9001 "Top Quality Standard" certification.

PRODUCTS

Zinc-Air Power Packs

BA-8180/U

Electric Fuel Zinc-Air power packs are lightweight, low-cost primary Zinc-Air batteries with up to twice the energy capacity per pound of primary lithium (LiSO₂) 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 LiSO₂ battery pack, has only 175 Wh/kg. Specific energy, or energy capacity per unit of weight, translates into longer operating times for battery-powered electronic equipment, and greater portability as well. Because of lower cost per watt-hour, the BA-8180/U can provide substantial cost savings to the Army when deployed for longer missions, even for applications that are not man-portable.

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

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

BA-8140/U

The BA-8140/U is a new product, presently being field tested and at its initial procurement

stages. The BA-8140/U is a smaller version of our 8180/U, which we developed at the request of CECOM. It is approximately half the size, weight and capacity of our 8180/U, and is appropriate for smaller hand-held communications devices.

Adapters

The BA-8180/U is a battery, but in order to connect it to a specific piece of equipment, an adapter must be used. In order to provide compatibility between the BA-8180/U and various items of military equipment, we supply various 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. In addition, we are in the process of adding more electrical interfaces for the BA-8180/U. These will address various applications, including other radios, night vision, missile launchers and chemical detectors.

Hybrids

We have also developed interface adapters for other items of equipment which require higher power than the BA-8180/U can provide by itself. For example, we have developed a hybrid battery system comprising a BA-8180/U battery pack and two small rechargeable lead-acid packs. Even with the weight of the lead-acid batteries, this hybrid system powers a satellite communications terminal for significantly longer than an equivalent weight of BA-5590 LiSO₂ battery packs. We have also developed experimental hybrid systems incorporating other rechargeable technologies, such as lithium-ion batteries and ultracapacitors.

Forward Field Chargers

One of the initial goals to develop high energy density and power density Zinc-Air was to deploy them as forward field chargers. It was envisioned that a man portable power pack would be required by the dismounted soldier to charge the range of rechargeable batteries now proliferating the military. A high efficiency forward field charger has been developed which enables either a BB-390/U (NiMH) or a BB-2590/U (Li-ion) to receive multiple charges from a single BA-8180/U.

Other Zinc-Air Products

A fourth generation of Zinc-Air products has been developed for applications where volume is critical, and/or where the power to energy ratio needs to be significantly higher than that of the BA-8180/U. These "Gen4" Zinc-Air products consist of an air cathode folded around a zinc electrode. Gen4 was originally developed for the Marine Corps Dragon Eye UAV, which requires up to 200 W from a battery that fits into its sleek fuselage and which weighs less than one kilogram. Along the way, it was recognized that the Gen4 design could be applied to other battery missions requiring high power as well as energy density, such as Land Warrior and Objective Force Warrior soldier systems, where up to 300 Wh of energy are required of a 24 hour battery that must be worn conformably, at minimal weight. For these systems the battery currently limits functionality, and Gen4 zinc-air may be the enabling technology.

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 continued actual flight testing. During 2003, our Zinc-Air battery successfully powered a Dragon Eye unmanned drone and an MAV in test flights, outperforming a competing technology, a high-performance lithium-ion polymer battery.

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. Our Zinc-Air battery successfully powered a Dragon Eye unmanned drone in a test flight in June 2003.

MAVs

Development of electrically propelled MAVs has been hampered by the lack of a satisfactory battery solution. Achievement of our develop-

ment targets will enable a Zinc-Air battery to power a typical 5-oz. MAV for as long as 30 minutes. Our Zinc-Air battery successfully powered an MAV in a test flight in June 2003, outperforming a competing technology, a high-performance lithium-ion polymer battery.

Lithium Batteries and Charging Systems for the Military

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

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

PRODUCTS

Epsilon currently produces over 50 different products in the following categories:

- Primary batteries
- Rechargeable batteries
- Smart chargers
- State of charge indicators
- Control and monitoring battery circuits

Epsilon's batteries are based on commercially-available battery cells that we purchase from several leading suppliers, with proprietary energy management circuitry and software. Epsilon's battery packs are designed to withstand harsh environments, and have a track record of years of service in armies worldwide.

Epsilon produces a wide range of primary batteries based on the following chemistries: lithium sulfur dioxide, lithium thionyl chloride, lithium manganese dioxide and alkaline. The rechargeable battery chemistries that Epsilon employs are: nickel cadmium, nickel metal hydride and lithium-ion. Epsilon manufactures single and multi-channel smart chargers for nickel cadmium, nickel metal hydride and lithium-ion batteries.

Epsilon has designed a number of sophisticated state of charge indicators. These are employed in Epsilon's products and are also sold as

components to other battery pack manufacturers. Epsilon also develops and manufactures control systems for high rate primary battery-packs and monitoring systems for rechargeable battery-packs.

Electric Vehicles

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. Electric Fuel-powered full-size vehicles, capable of clean, 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.

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 bus;
- an automated battery refueling system for mechanically replacing depleted zinc-fuel cassettes with charged cassettes; and
- a regeneration system for electrochemical recycling and mechanical repacking of the discharged fuel cassettes.

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

similar to that of conventionally powered vehicles.

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

In the United States, our Zinc-Air technology is the focus of a Zinc-Air All Electric Bus demonstration program the costs and expenditures of which are 50% offset by subcontracting fees paid by the U.S. Department of Transportation's Federal Transit Administration (FTA). The test program is designed to prove that an all-electric bus can meet these and all other Los Angeles and New York Municipal Transit Authority mass transit requirements including requirements relating to performance, speed, acceleration and hill climbing.

The bus used in the program, which includes General Electric and the Regional Transportation Commission of Southern Nevada (RTC) as project partners, 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.

During Phase II of 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 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. We have now completed Phase III of the project, which focused on installation, testing and commissioning of new generation advanced ultracapacitors and associated interface controls, and culminated in a performance evaluation test in Schenectady and Albany, New

York, with the participation of New York Assembly Speaker Sheldon Silver, in November 2003.

Phase IV of the program, which we began in October 2003, is a \$1.5 million cost-shared program (half of which is funded by the FTA and the remainder by the program partners, including us) that will explore steps necessary for commercializing the all-electric zinc-air/ultracapacitor hybrid bus. It will focus on continued optimization of the propulsion system developed in previous phases, on additional vehicle and system testing, including testing alternative advanced auxiliary battery technologies, and on evaluating alternative zinc anodes, which are more commercially available in North America.

Lifejacket Lights

In 1996, we began to produce and market lifejacket lights built with our patented magnesium-cuprous chloride batteries, which are activated by immersion in water (water-activated batteries), for the aviation and marine safety and emergency markets. At present we have a product line consisting of five lifejacket light models, three for use with marine life jackets and two for use with aviation life vests, all of which work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations. We manufacture, assemble and package all our lifejacket lights in our factory in Beit Shemesh, Israel.

Armored Vehicle Division

MDT Protective Industries and MDT Armor

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 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 pro-

vided 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.

In 2003, MDT Armor established operations in a new facility in Auburn, Alabama. Soon thereafter, the United States General Services Administration (GSA) awarded a five-year contract to MDT Armor for vehicle armoring, establishing a pricing schedule for armoring of GM Suburban and Toyota Land Cruiser SUVs and of GM Savana/Express passenger vans. With this contract, these armored vehicles became available for purchase directly by all federal agencies beginning December 1, 2003.

MDT's revenues during 2001, 2002 and 2003 were approximately \$6.8 million, \$6.4 million and \$3.4 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 armor 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 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 do not obstruct the driver's or passengers' views. 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 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

➤ command vehicles (such as the Land Rover Defender 4×4)

➤ specialty vehicles

In the commercial market, MDT armors:

➤ sports utility vehicles (such as the GM Suburban, the Toyota Land Cruiser and the Land Rover Defender)

➤ passenger vans (such as the Chevrolet Savana, the General Motors Vandura and the Ford Econoline)

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, 2003 and 2002, our backlog for the following years was approximately \$17.2 million and \$7.2 million, respectively, divided among our product lines as follows (backlog for product lines acquired after December 31, 2003 is given as it stood at such date in the books of the seller, prior to the acquisition):

Division	Product Line	2003	2002
Simulation, Training and Consulting Division	Use-of-force training	\$ 334,000	\$2,690,000
	Vehicle simulators*	6,206,000	—
	Security consulting.....	60,000	—
Battery and Power Systems Division	Zinc-Air military batteries	5,250,000	2,700,000
	Lithium military batteries*..	3,800,000	—
	Electric vehicle.....	436,000	420,000
	Water-activated batteries..	144,000	300,000
Armored Vehicle Division	Car armoring	931,000	1,040,000
	TOTAL:	\$17,161,000	\$7,150,000

* Not owned at December 31, 2002.

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, 2003	High	Low
Fourth Quarter.....	\$ 2.86	\$ 1.28
Third Quarter.....	\$ 1.62	\$ 0.81
Second Quarter.....	\$ 1.19	\$ 0.49
First Quarter.....	\$ 0.66	\$ 0.43
Year Ended December 31, 2002		
Fourth Quarter.....	\$ 1.06	\$ 0.61
Third Quarter.....	\$ 1.59	\$ 0.83
Second Quarter.....	\$ 1.68	\$ 0.73
First Quarter.....	\$ 2.20	\$ 1.42

As of February 29, 2004 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 five fiscal years in the period ended December 31, 2003, 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 & Kassierer, 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, 2003, 2002, 2001, 2000 and 1999 have been reclassified in the accompanying statements of operations as discontinued operations. Our balance sheets at December 31, 2003, 2002, 2001, 2000 and 1999 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 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,				
	1999	2000	2001	2002	2003
	(dollars in thousands, except per share data)				
Statement of Operations Data:					
Revenues.....	\$ 2,422	\$ 1,490	\$ 2,094	\$ 6,407	\$ 17,326
Research and development expenses and costs of revenues.....	3,867	1,985	2,448	5,108	12,141
Selling, general and administrative expenses and amortization of intangible assets	2,754	3,434	3,934	5,982	10,594
Operating loss.....	(4,198)	(3,929)	(4,288)	(4,683)	(5,409)
Financial income (expenses), net	190	544	263	100	(3,470)
Loss before minority interest in loss (earnings) of subsidiary and tax expenses	(4,008)	(3,385)	(4,026)	(4,583)	(8,879)
Taxes on income	6	—	—	—	(396)
Minority interest in loss (earnings) of subsidiary ..	—	—	—	(355)	157
Loss from continuing operations	(4,014)	(3,385)	(4,026)	(4,938)	(9,118)
Income (loss) from discontinued operations	(2,902)	(8,596)	(13,261)	(13,566)	110
Net loss for the period.....	(6,916)	(11,981)	(17,287)	(18,504)	(9,008)
Deemed dividend to certain shareholders of common stock	—	—	(1,197)	—	—
Net loss attributable to shareholders of common stock	\$ (6,916)	\$ (11,981)	\$ (18,483)	\$ (18,504)	\$ (9,008)
Basic and diluted net loss per share from continuing operations	\$ (0.28)	\$ (0.18)	\$ (0.21)	\$ (0.15)	\$ (0.23)
Loss per share for combined operations.....	\$ (0.48)	\$ (0.62)	\$ (0.76)	\$ (0.57)	\$ (0.23)
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands).....	14,334	19,243	24,200	32,382	38,890
	As At December 31,				
	1999	2000	2001	2002	2003
Balance Sheet Data:					
Cash, cash equivalents, investments in marketable debt securities and restricted collateral deposits	\$ 2,556	\$ 11,596	\$ 12,672	\$ 2,091	\$ 14,391
Receivables and other assets	5,215	13,771	11,515	7,895	8,898
Property and equipment, net of depreciation	2,258	2,289	2,221	2,555	2,293
Goodwill and other intangible assets, net	—	—	—	7,522	7,440
Total assets	\$ 10,029	\$ 27,656	\$ 26,408	\$ 20,063	\$ 33,022
Current liabilities*	\$ 3,427	\$ 4,787	\$ 3,874	\$ 7,272	\$ 6,860
Long-term liabilities*	2,360	2,791	3,126	3,753	4,118
Stockholders' equity	4,242	20,078	19,408	9,038	22,044
Total liabilities and stockholders equity	\$ 10,029	\$ 27,656	\$ 26,408	\$ 20,063	\$ 33,022

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

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

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

General

We are a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate in three business units:

- We develop, manufacture and market advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement and security personnel, as well as offering security consulting and other services (our ***Simulation, Training and Consulting Division***);
- We manufacture and sell Zinc-Air and lithium batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles (our ***Battery and Power Systems Division***); and
- We utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our ***Armored Vehicle Division***).

Early in 2004, we acquired two new businesses: FAAC Corporation, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (which we have placed in our Simulation, Training and Consulting Division), and Epsilon Electronic Industries, Ltd., located in Dimona, Israel, which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia (which we have placed in our Battery and Power Systems Division).

Prior to the acquisition of FAAC and Epsilon, we were organized into two divisions: Defense and Security Products (consisting of IES, MDT, MDT Armor and Arocon), and Electric Fuel Batteries (consisting of EFL and EFB). We have reported our results of operations for 2003 and 2002 in accordance with these earlier divisions, and our financial results for 2003 and 2002 do not include the activities of FAAC or Epsilon.

Critical Accounting Policies

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

We believe the following critical accounting policies, 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; from sale of zinc-air battery products for defense applications; and, to a lesser extent, 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. We make judgments as to our ability to collect outstanding receivables and provide allowances for a portion of such receivables when and if collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding receivables. In determining the provision, we analyze our historical collection experience and current economic trends. If the historical data we use to calculate the allowance provided for doubtful accounts does not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed and the future results of operations could be materially affected.

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.

The complexity of the estimation process and the issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our consolidated financial statements.

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory

write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2003, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

Our business acquisitions typically result in the recognition of goodwill and other intangible assets, which affect the amount of current and future period charges and amortization expenses. The determination of value of these components of a business combination, as well as associated asset useful lives, requires our management to make various estimates and assumptions. Estimates using different, but each reasonable, assumptions could produce significantly different results. We test goodwill for possible impairment on an annual basis and at any other time if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Such impairment loss is measured by comparing the recoverable amount of an asset with its carrying value. The determination of the value of goodwill requires our management to make assumptions regarding estimated future cash flows and other factors to determine the fair value of a respective asset. 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.

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, 2003, 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. These estimates have been based on our business plans for the entities acquired. 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.

Functional Currency

We consider the United States dollar to be the currency of the primary economic environment in which we and our Israeli subsidiary EFL operate and, therefore, both we and EFL have adopted and are using the United States dollar as our functional currency. Transactions and balances originally denominated in U.S. dollars are presented at the original amounts. Gains and losses arising from non-dollar transactions and balances are included in net income.

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

Executive Summary

The following executive summary includes, where appropriate, discussion of our two new subsidiaries, FAAC Incorporated and Epsilon Electronic Industries, Ltd., that we purchased early in 2004. The results of these subsidiaries are not included in our results of operations for 2003 and 2002, but are included in this discussion to the extent that they are relevant to our

anticipated financial condition and results of operations going forward.

Divisions and Subsidiaries

We operate primarily as a holding company, through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned, unless otherwise noted) are as follows:

➤ Our ***Simulation, Training and Consulting Division***, consisting of:

- IES Interactive Training, Inc., located in Littleton, Colorado, which provides specialized "use of force" training for police, security personnel and the military ("IES");
- FAAC Incorporated, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry ("FAAC"); and
- Arocon Security Corporation, located in New York, New York, which provides security consulting and other services, focusing on protecting life, assets and operations with minimum hindrance to personal freedom and daily activities ("Arocon").

➤ Our ***Battery and Power Systems Division***, consisting of:

- Electric Fuel Battery Corporation, located in Auburn, Alabama, which manufactures and sells Zinc-Air fuel cells, batteries and chargers for the military, focusing on applications that demand high energy and light weight ("EFB");
- Epsilon Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area), which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia ("Epsilon"); and
- Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel, which produces water-activated lifejacket lights for commercial aviation and marine applications, and which con-

ducts our Electric Vehicle effort, focusing on obtaining and implementing demonstration projects in the U.S. and Europe, and on building broad industry partnerships that can lead to eventual commercialization of our Zinc-Air energy system for electric vehicles (“EFL”).

➤ Our **Armored Vehicle Division**, consisting of:

- MDT Protective Industries, Ltd., located in Lod, Israel, which specialize in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and cars, and is a leading supplier to the Israeli military, Israeli special forces and special services (“MDT”), (75.5% owned); and
- MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT’s United States activities (“MDT Armor”) (88% owned).

Prior to the acquisition of FAAC and Epsilon, we were organized into two divisions: Defense and Security Products (consisting of IES, MDT, MDT Armor and Arocon), and Electric Fuel Batteries (consisting of EFL and EFB). We have reported our results of operations for 2003 and 2002 in accordance with these earlier divisions.

Overview of Results of Operations

We incurred significant operating losses for the years ended December 31, 2003, 2002 and 2001. While we expect to continue to derive revenues from the sale of products that we manufacture and the services that we provide, there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis.

During 2003, we substantially increased our revenues and reduced our operating loss, from \$18.5 million in 2002 to \$9.0 million in 2003. This was achieved through a combination of cost-cutting measures and increased revenues, particularly from the sale of Zinc-Air batteries to the military and from sales of interactive training systems by IES. We believe that our new acquisitions, FAAC and Epsilon, will contribute to our goal of achieving profitability.

We regard moving the company to a positive cash flow situation on a consistent basis to be

an important goal, and we are focused on achieving that goal for the second half of 2004 and beyond. In this connection, we note that most of our business lines historically have had weaker first halves than second halves, and weaker first quarters than second quarters. We expect this to be the case for 2004 as well.

A portion of our operating loss during 2003 arose as a result of non-cash charges. These charges were primarily related to our acquisitions and to our raising capital. Because we anticipate continuing these activities during 2004, we expect to continue to incur such non-cash charges in the future.

Non-cash charges related to acquisitions arise when the purchase price for an acquired company exceeds the company’s book value. In such a circumstance, a portion of the excess of the purchase price is recorded as goodwill, and a portion as intangible assets. In the case of goodwill, the assets recorded as goodwill are not amortized; instead, we are required to perform an annual impairment review. If we determine, through the impairment review process, that goodwill has been impaired, we must record the impairment charge in our statement of operations. Intangible assets are amortized in accordance with their useful life. Accordingly, for a period of time following an acquisition, we incur a non-cash charge in the amount of a fraction (based on the useful life of the intangible assets) of the amount recorded as intangible assets. Such non-cash charges will continue during 2004; additionally, our acquisitions of FAAC and Epsilon will result in our incurring similar non-cash charges beginning in 2004.

As a result of the application of the above accounting rule, we incurred non-cash charges in the amount of \$865,000 during 2003. See “Critical Accounting Policies – Goodwill,” above.

As a result of the application of the above accounting rule, we incurred non-cash charges in the amount of \$3.4 million during 2003.

Additionally, in an effort to improve our cash situation and our shareholders’ equity, and in order to reduce the number of our outstanding warrants, during 2003 we induced holders of certain of our warrants to exercise their warrants by lowering the exercise price of the warrants to approximately market value in exchange for immediate exercise of such warrants, and by issuing to such investors a lower number of new warrants at a higher exercise price. Under such circumstances, accounting rules require us to

record a compensation expense in an amount determined based upon the fair value of the new warrants (using a Black-Scholes pricing model). As and to the extent that we engage in similar warrant repricings and issuances in the future, we would incur similar non-cash charges.

As a result of the application of the above accounting rule, we incurred non-cash charges in the amount of \$388,000 during 2003.

We also incurred a non-cash charge in the amount of \$839,000 during 2003 arising out of the shares and warrants we granted to IES Electronics in connection with the settlement of our litigation with them, as a result of and expense in an amount determined based upon the fair value of these warrants (using a Black-Scholes pricing model). This charge is not expected to recur.

Overview of Financial Condition and Operating Performance

We shut down our money-losing consumer battery operations and began acquiring new businesses in the defense and security field in 2002. Since then, we have concentrated on eliminating our operating deficit and moving Arotech to cash-flow positive operations. In order to do this, we have focused on acquiring businesses with strong revenues and profitable operations.

In our Defense and Security Products Division, MDT experienced a slowdown in revenues during 2003 because MDT's primary customer, the Israel Defense Forces, reduced orders as a result of cuts in that portion of its budget that it can spend in Israel. We noted this trend in 2003 and began to work on reversing it by opening production facilities for MDT Armor in Auburn, Alabama. As of December 31, 2003, our backlog for MDT totaled \$931,000, most of which was from orders from customers other than the Israel Defense Forces.

IES had record sales in 2003; IES sales have grown from \$3.5 million in 2001 (before we owned it) to more than \$8.0 million in 2003. We attribute this to a number of substantial orders, such as orders from the German Police and from the United States Department of Health and Human Services. Since sales of new IES simulation systems (as opposed to upgrades and additions) have a very long sales cycle, it is difficult to predict what sales will be like in 2004. As of December 31, 2003, our backlog for IES totaled \$334,000.

In our Electric Fuel Batteries Division, EFB had its first sales in 2003. These sales were almost exclusively from the United States Army, which continues to use our BA-8180 Zinc-Air battery for its CECOM division. We believe the war in Iraq had a substantial positive effect on our sales in 2003. However, we are hopeful that since the war came at a time when we were just beginning the introduction of our batteries to the Army, much of the falloff in use of our products that would normally be expected to occur at the war's end (which is not presently anticipated to occur in the immediate future) will be offset by growing acceptance of our batteries by soldiers in the field and their supply officers. As of December 31, 2003, our backlog for EFB totaled \$5.3 million.

We do not anticipate a substantial change in our revenues from EFL, either from the water-activated battery line or from the electric vehicle. In this connection, we have begun an effort to find external financing for development of our electric vehicle in the form of a partnership or joint venture, but there can be no assurance that we will succeed in this effort, and we do not anticipate that our electric vehicle program will provide significant revenues in 2004.

We anticipate that our acquisitions of Epsilon and FAAC, which occurred in January 2004, will add to our revenues, our gross profit and our cash flow in 2004.

Results of Operations

Preliminary Note

Results for the years ended December 31, 2003 and 2002 include the results of IES and MDT for such periods as a result of our acquisitions of these companies early in the third quarter of 2002. However, the results of IES and MDT were not included in our operating results for the full year ended December 31, 2002. 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.

Following is a table summarizing our results of operations for the years ended December 31, 2003 and 2002, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2003	2002
Revenues:		
Defense and Security Products.....	\$ 11,457,741	\$ 4,724,443
Electric Fuel Batteries	5,868,899	1,682,296
All other	—	—
	<u>\$17,326,641</u>	<u>\$ 6,406,739</u>
Cost of revenues:		
Defense and Security Products.....	\$ 6,566,252	\$ 2,380,387
Electric Fuel Batteries	4,521,588	2,041,361
All other	—	—
	<u>\$11,087,840</u>	<u>\$ 4,421,748</u>
Research and development expenses:		
Defense and Security Products.....	\$ 216,800	\$ 175,796
Electric Fuel Batteries	836,608	510,123
All other	—	—
	<u>\$ 1,053,408</u>	<u>\$ 685,919</u>
Sales and marketing expenses:		
Defense and Security Products.....	\$ 2,418,017	\$ 636,066
Electric Fuel Batteries	926,872	673,601
All other	187,747	—
	<u>\$ 3,532,636</u>	<u>\$ 1,309,669</u>
General and administrative expenses:		
Defense and Security Products.....	\$ 1,519,458	\$ 833,610
Electric Fuel Batteries	188,655	89,945
All other	4,488,666	3,099,548
	<u>\$ 6,196,779</u>	<u>\$ 4,023,103</u>
Financial expense (income):		
Defense and Security Products.....	\$ (139,668)	\$ (4,556)
Electric Fuel Batteries	7,936	—
All other	3,602,191	(95,895)
	<u>\$ 3,470,459</u>	<u>\$ (100,451)</u>
Tax expenses:		
Defense and Security Products.....	\$ 393,303	\$ —
Electric Fuel Batteries	—	—
All other	2,890	—
	<u>\$ 396,193</u>	<u>\$ —</u>
Amortization of intangible assets:		
Defense and Security Products.....	\$ 864,910	\$ 649,543
Electric Fuel Batteries	—	—
All other	—	—
	<u>\$ 864,910</u>	<u>\$ 649,543</u>
Minority interest in loss (profit) of subsidiaries:		
Defense and Security Products.....	\$ 156,900	\$ (355,360)
Electric Fuel Batteries	—	—
All other	—	—
	<u>\$ 156,900</u>	<u>\$ (355,360)</u>
Net loss from continuing operations:		
Defense and Security Products.....	\$ 224,431	\$ 301,765
Electric Fuel Batteries	612,760	1,632,734
All other	8,281,493	3,003,653
	<u>\$ 9,118,684</u>	<u>\$ 4,938,152</u>
Net loss (profit) from discontinued operations:		
Defense and Security Products.....	\$ —	\$ —
Electric Fuel Batteries	(110,410)	13,566,206
All other	—	—
	<u>\$ (110,410)</u>	<u>\$ 13,566,206</u>
Net loss:		
Defense and Security Products.....	\$ 224,431	\$ 301,765
Electric Fuel Batteries	502,350	15,198,940
All other	8,281,493	3,003,653
	<u>\$ 9,008,274</u>	<u>\$ 18,504,358</u>

Fiscal Year 2003 compared to Fiscal Year 2002

Revenues. During 2003, we (through our subsidiaries) recognized revenues as follows:

- IES recognized revenues from the sale of interactive use-of-force training systems and

from the provision of warranty services in connection with such systems

- MDT recognized revenues from payments under vehicle armoring contracts and for service and repair of armored vehicles;
- EFB recognized revenues from the sale of batteries and adapters to the military, and under certain development contracts with the U.S. Army;
- Arocon recognized revenues under consulting agreements; and
- EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase III of the United States Department of Transportation (DOT) electric bus program, which began in October 2002 and was completed in March 2004. Phase IV of the DOT program, which began in October 2003, did not result in any revenues during 2003.

Revenues from continuing operations for the year ended December 31, 2003 totaled \$17.3 million, compared to \$6.4 million for 2002, an increase of \$10.9 million, or 170%. This increase was primarily the result of increased sales attributable to IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002.

In 2003, revenues were \$11.5 million for the Defense and Security Products Division (compared to \$4.7 million in 2002, an increase of \$6.7 million, or 143%, due primarily to increased sales on the part of IES, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002), and \$5.9 million for the Electric Fuel Batteries Division (compared to \$1.7 million in the comparable period in 2002, an increase of \$4.2 million, or 249%, due primarily to increased sales to the U.S. Army on the part of EFB).

Cost of revenues and gross profit. Cost of revenues totaled \$11.1 million during 2003, compared to \$4.4 million in 2002, an increase of \$6.7 million, or 151%, due to increased cost of goods sold, particularly by IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002.

Direct expenses for our two divisions during 2003 were \$10.9 million for the Defense and Security Products Division (compared to \$4.4 million in 2002, an increase of \$6.5 million, or 150%, due primarily to increased sales attributable to IES, as well as the inclusion of IES and MDT in our results

for the full year of 2003 but only part of 2002), and \$5.9 million for the Electric Fuel Batteries Division (compared to \$3.1 million in the comparable period in 2002, an increase of \$2.9 million, or 94%, due primarily to increased sales on the part of EFB to the U.S. Army).

Gross profit was \$6.2 million during 2003, compared to \$2.0 million during 2002, an increase of \$4.3 million, or 214%. This increase was the direct result of all factors presented above, most notably the increased sales of IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002. In 2003, IES contributed \$4.1 million to our gross profit, EFB contributed \$1.6 million, and MDT contributed \$833,000.

Research and development expenses. Research and development expenses for 2003 were \$1.1 million, compared to \$686,000 in 2002, an increase of \$367,000, or 54%. This increase was primarily because certain research and development personnel who had worked on the discontinued consumer battery operations during 2002 (the expenses of which are not reflected in the 2002 number above) were reassigned to military battery research and development in 2003.

Sales and marketing expenses. Sales and marketing expenses for 2003 were \$3.5 million, compared to \$1.3 million in 2002, an increase of \$2.2 million, or 170%. This increase was primarily attributable to the following factors:

- The inclusion of the sales and marketing expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;
- An increase in IES's sales activity during 2003, which resulted in both increased sales and increased sales and marketing expenses during 2003; and
- We incurred expenses for consultants in the amount of \$810,000 in connection with our CECOM battery program with the U.S. Army and \$345,000 in connection with our security consulting business.

General and administrative expenses. General and administrative expenses for 2003 were \$6.2 million, compared to \$4.0 million in 2002, an increase of \$2.2 million, or 54%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;

- Expenses in 2003 in connection with a litigation settlement agreement, in the amount of \$864,000, that were not present in 2002;
- Expenses in 2003 in connection with warrant repricings, in the amount of \$388,000, that were not present in 2002;
- Legal and consulting expenses in 2003 in connection with our convertible debentures, in the amount of \$484,000, that were not present in 2002; and
- Expenses in 2003 in connection with the start-up of our security consulting business in the United States and with the beginning of operations of MDT Armor, in the amount of \$250,000, that were not present in 2002.

Financial income (expense). Financial expense totaled approximately \$3.5 million in 2003 compared to financial income of \$100,000 in 2002, an increase of \$3.6 million. This increase was due primarily to amortization of compensation related to the issuance of convertible debentures issued in December 2002 and during 2003 in the amount of \$3.4 million, and interest expenses related to those debentures in the amount of \$376,000.

Tax expenses. We and our Israeli subsidiary EFL incurred net operating losses during 2003 and 2002 and, accordingly, we were not required to make any provision for income taxes. MDT and IES had taxable income, and accordingly we were required to make provision for income taxes in the amount of \$396,000 in 2003. We were able to offset IES's federal taxes against our loss carryforwards. In 2002 we did not accrue any tax expenses due to our belief that we would be able to utilize our loss carryforwards against MDT's taxable income, estimation was revised in 2003. Of the amount accrued in 2003, approximately \$352,000 was accrued on account of income in 2002.

Amortization of intangible assets and in-process research and development. Amortization of intangible assets totaled \$865,000 in 2003, compared to \$649,000 in 2002, an increase of \$215,000, or 33%, resulting from amortization of these assets subsequent to our acquisition of IES and MDT in 2002. Of this \$215,000 increase, \$169,000 was attributable to IES and \$46,000 was attributable to MDT.

Loss from continuing operations. Due to the factors cited above, we reported a net loss from continuing operations of \$9.1 million in 2003,

compared to a net loss of \$4.9 million in 2002, an increase of \$4.2 million, or 85%.

Profit (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 years ended December 31, 2003 and 2002 in an item entitled "Loss from discontinued operations."

Profit from discontinued operations in 2003 was \$110,000, compared to a net loss of \$13.6 million in 2002, a decrease of \$13.7 million. This decrease was the result of the elimination of the losses from these discontinued operations beginning with the fourth quarter of 2002. The profit from discontinued operations was primarily from cancellation of past accruals made unnecessary by the closing of the discontinued operations.

Net loss. Due to the factors cited above, we reported a net loss of \$9.0 million in 2003, compared to a net loss of \$18.5 million in 2002, a decrease of \$9.5 million, or 51%.

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 a decrease in general and administrative 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.

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%.

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."

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 \$18.5 million in 2002, compared to a net loss of \$17.3 million in 2001, an increase of \$1.2 million, or 7%.

Liquidity and Capital Resources

As of December 31, 2003, we had cash and cash equivalents of approximately \$13.7 million, compared with \$1.5 million as of December 31, 2002, an increase of \$12.2 million, or 839%. The increase in cash was primarily the result of sales of our securities during 2003. In January 2004, we raised an additional \$17.8 million, net of expenses, through additional sales of our securities. As of

February 29, 2004, our cash totaled approximately \$4.2 million, not including approximately \$9.1 million held in restricted deposits to fund future obligations in connection with such acquisitions, primarily as a result of our use of cash for the Epsilon and FAAC acquisitions.

We used available funds in 2003 primarily for working capital needs. We increased our investment in fixed assets by \$585,000 during the year ended December 31, 2003, primarily in the Electric Fuel Batteries Division. Our fixed assets amounted to \$2.3 million as at year end.

Net cash used in operating activities from continuing operations for 2003 and 2002 was \$3.0 million and \$3.5 million, respectively, a decrease of \$465,000, or 13%. This decrease was primarily the result of changes in operating assets and liabilities, such as accounts payable and inventory.

Net cash used in investing activities for 2003 and 2002 was \$1.8 million and \$5.4 million, respectively, a decrease of \$3.6 million, or 66%. This decrease was primarily the result of our investment in the acquisition of IES and MDT in 2002.

Net cash provided by financing activities for 2003 and 2002 was \$17.4 million and \$3.1 million, respectively, an increase of \$14.3 million, or 464%. This increase was primarily the result of higher amounts of funds raised through sales of our securities in 2003 compared to 2002.

During 2003, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately \$434,000.

On September 30, 2003 we issued and sold to various institutional investors an aggregate \$5,000,000 principal amount of 8% Secured Convertible Debentures due September 30, 2006, as more fully described in the Current Report on Form 8-K that we filed with the Securities and Exchange Commission on October 3, 2003.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2003:

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt	\$ 8,525,000	\$ —	\$ 8,525,000	\$ —	\$ —
Short-term debt	\$ 190,849	\$ 190,849	\$ —	\$ —	\$ —
Operating lease obligations ...	\$ 590,778	\$ 393,512	\$ 197,266	\$ —	\$ —
Severance obligations	\$ 1,749,391	\$ 183,056	\$ 1,387,738	\$ —	\$ 178,597

* Includes convertible debentures in the gross amount of \$8,375,000. Unamortized financial expenses related to the beneficial conversion feature of these convertible debentures amounted to \$7,493,056 at year end.

On December 18, 2002 we issued and sold to various institutional investors an aggregate \$6,000,000 principal amount of 8% Secured Convertible Debentures due December 31, 2006.

We have approximately \$10.5 million in long term debt outstanding, of which \$8.4 million was convertible debt, and approximately \$6.9 million in short-term debt.

We believe that our present cash position and anticipated cash flows from operations should be sufficient to satisfy our current estimated cash requirements through the next year. Over the long term, we will need to become profitable, at least on a cash-flow basis, and maintain that profitability in order to avoid future capital requirements. Additionally, we would need to raise additional capital in order to fund any future acquisitions.

Our current debt agreements grant to our investors a right of first refusal on any future financings, except for underwritten public offerings in excess of \$30 million. We do not believe that this covenant will materially limit our ability to undertake future financings.

Effective Corporate Tax Rate

Arotech and EFL have incurred net operating losses or had earnings arising from tax-exempt income during the years ended December 31, 2001, 2002 and 2003 and accordingly no provision for income taxes was required. Taxes in these entities paid in 2001, 2002 and 2003 are primarily composed of United States federal alternative minimum taxes.

As of December 31, 2003, we had U.S. net operating loss carry forwards of approximately \$17.0 million that are available to offset future taxable income, expiring primarily in 2015, and foreign net operating and capital loss carry forwards of approximately \$84.0 million, which are available indefinitely to offset future taxable income.

REPORT OF INDEPENDENT AUDITORS**To the Shareholders of****AROTECH CORPORATION**

We have audited the accompanying consolidated balance sheets of Arotech Corporation (formerly known as Electric Fuel Corporation) (the "Company") and its subsidiaries as of December 31, 2003 and 2002, 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, 2003. Our audits also included the financial statement schedule listed in Item 15(a)(2) of the Company's 10-K. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We 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, 2003 and 2002, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States. Additionally, in our opinion the related financial statement schedule, when considered in relation to the basic financial statements and schedule taken as a whole, present fairly in all material respects the information set forth therein.

Tel Aviv, Israel
March 9, 2004KOST, FORER, GABBAY & KASSIERER
A Member of Ernst & Young Global

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2003	2002
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 13,685,125	\$ 1,457,526
Restricted collateral deposit and other restricted cash	706,180	633,339
Trade receivables (net of allowance for doubtful accounts in the amounts of \$61,282 and \$40,636 as of December 31, 2003 and 2002, respectively)	4,706,423	3,776,195
Other accounts receivable and prepaid expenses	1,187,371	1,032,311
Inventories	1,914,748	1,711,479
Assets of discontinued operations	66,068	349,774
Total current assets	<u>22,265,915</u>	<u>8,960,624</u>
SEVERANCE PAY FUND	1,023,342	1,025,071
PROPERTY AND EQUIPMENT, NET	2,292,741	2,555,249
GOODWILL	5,064,555	4,954,981
OTHER INTANGIBLE ASSETS, NET	<u>2,375,195</u>	<u>2,567,457</u>
	<u>\$ 33,021,748</u>	<u>\$20,063,382</u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2003	2002
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short term bank loans	\$ 40,849	\$ 108,659
Trade payables	1,967,448	2,900,117
Other accounts payable and accrued expenses	4,321,347	2,009,109
Current portion of promissory note	150,000	1,200,000
Liabilities of discontinued operations	380,108	1,053,798
Total current liabilities	6,859,752	7,271,683
LONG TERM LIABILITIES		
Accrued severance pay	2,814,492	2,994,233
Convertible debenture	881,944	—
Deferred warranty revenue	220,143	—
Promissory note	150,000	516,793
Total long-term liabilities	4,066,579	3,511,026
COMMITMENTS AND CONTINGENT LIABILITIES		
MINORITY INTEREST	51,290	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: 47,972,407 shares and 35,701,594 shares as of December 31, 2003 and 2002, respectively; Outstanding – 47,417,074 shares and 35,146,261 shares as of December 31, 2003 and 2002, respectively	479,726	357,017
Preferred shares – \$0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2003 and 2002; No shares issued and outstanding as of December 31, 2003 and 2002		—
Additional paid-in capital	135,891,316	114,082,584
Accumulated deficit	(109,681,893)	(100,673,619)
Deferred stock compensation	(8,464)	(12,000)
Treasury stock, at cost (common stock – 555,333 shares as of December 31, 2003 and 2002)	(3,537,106)	(3,537,106)
Notes receivable from shareholders	(1,203,881)	(1,177,589)
Accumulated other comprehensive loss	104,429	(1,786)
Total shareholders' equity	22,044,127	9,037,501
	<u>\$ 33,021,748</u>	<u>\$20,063,382</u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

In U.S. dollars

	Year ended December 31,		
	2003	2002	2001
Revenues:			
Products	\$ 16,918,480	\$ 5,944,370	\$ 1,670,634
Services	408,161	462,369	422,998
Total revenues	17,326,641	6,406,739	2,093,632
Cost of revenues	11,087,840	4,421,748	1,992,636
Gross profit	6,238,801	1,984,991	100,996
Operating expenses:			
Research and development, net	1,053,408	685,919	455,845
Selling and marketing expenses	3,532,636	1,309,669	105,977
General and administrative expenses	6,196,779	4,023,103	3,827,544
Amortization of intangible assets	864,910	623,543	-
In-process research and development write-off	-	26,000	-
Total operating costs and expenses	11,647,733	6,668,234	4,389,366
Operating loss	(5,408,932)	(4,683,243)	(4,288,370)
Financial income (expenses), net	(3,470,459)	100,451	262,581
Loss before minority interest in loss (earnings) of a subsidiary and tax expenses	(8,879,391)	(4,582,792)	(4,025,789)
Tax expenses	(396,193)	-	-
Minority interest in loss (earnings) of a subsidiary	156,900	(355,360)	-
Loss from continuing operations	(9,118,684)	(4,938,152)	(4,025,789)
Income (loss) from discontinued operations (including loss on disposal of \$4,446,684 during 2002)	110,410	(13,566,206)	(13,260,999)
Net loss	\$ (9,008,274)	\$ (18,504,358)	\$ (17,286,788)
Deemed dividend to certain shareholders of common stock	\$ -	\$ -	\$ (1,196,667)
Net loss attributable to shareholders of common stock	\$ (9,008,274)	\$ (18,504,358)	\$ (18,483,455)
Basic and diluted net loss per share from continuing operations	\$ (0.23)	\$ (0.15)	\$ (0.21)
Basic and diluted net loss per share from discontinued operations	\$ 0.00	\$ (0.42)	\$ (0.55)
Basic and diluted net loss per share	\$ (0.23)	\$ (0.57)	\$ (0.76)
Weighted average number of shares used in computing basic and diluted net loss per share	38,890,174	32,381,502	24,200,184

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

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

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	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 repay- ment of the related interest and principal of notes from share- holders	—	—	228,674	—	—	(3,499,375)		3,470,431	199,730
Issuance of shares to investors, net	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							<u>\$(17,286,788)</u>		
Balance as of December 31, 2001	<u>29,059,469</u>	<u>\$ 290,596</u>	<u>\$105,686,909</u>	<u>\$(82,169,261)</u>	<u>\$ (18,000)</u>	<u>\$ (3,537,106)</u>		<u>\$ (845,081)</u>	<u>\$ 19,408,057</u>

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

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

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	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							<u>\$ (18,506,144)</u>			
Balance as of December 31, 2002	<u>35,701,594</u>	<u>\$ 357,017</u>	<u>\$114,082,584</u>	<u>\$(100,673,619)</u>	<u>\$ (12,000)</u>	<u>\$(3,537,106)</u>		<u>\$(1,177,589)</u>	<u>\$ (1,786)</u>	<u>\$ 9,037,501</u>

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

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

	Common stock		Additional paid-in capital	Accumulated deficit	Deferred stock compensation	Treasury stock	Notes receivable from shareholders	Accumulated other comprehensive loss	Total comprehensive loss	Total shareholders' equity
	Shares	Amount								
Balance as of January 1, 2003	35,701,594	\$ 357,017	\$114,082,584	\$(100,673,619)	\$ (12,000)	\$(3,537,106)	\$(1,177,589)	\$ (1,786)		\$ 9,037,501
Compensation related to warrants issued to the holders of convertible debentures			5,157,500							5,157,500
Compensation related to beneficial conversion feature of convertible debentures			5,695,543							5,695,543
Issuance of shares on conversion of convertible debentures	6,969,605	69,696	6,064,981				(9,677)			6,125,000
Issuance of shares on exercise of warrants	3,682,997	36,831	3,259,422							3,296,253
Issuance of shares to consultants	223,600	2,236	159,711							161,947
Compensation related to warrants and options issued to consultants and investors			418,162							418,162
Compensation related to non-recourse loan granted to shareholder			38,500							38,500
Deferred stock compensation			4,750		(4,750)					—
Amortization of deferred stock compensation					8,286					8,286
Exercise of options by employees	689,640	6,896	426,668							433,564
Exercise of options by consultants	15,000	150	7,200							7,350
Conversion of convertible promissory note	563,971	5,640	438,720							444,360
Increase in investment in subsidiary against common stock issuance	126,000	1,260	120,960							122,220
Accrued interest on notes receivable from shareholders			16,615				(16,615)			—
Other comprehensive loss – foreign currency translation adjustment								106,215	106,215	106,215
Net loss				(9,008,274)					(9,008,274)	(9,008,274)
									(8,902,059)	
Balance as of December 31, 2003	<u>47,972,407</u>	<u>\$ 479,726</u>	<u>\$135,891,316</u>	<u>\$(109,681,893)</u>	<u>\$ (8,464)</u>	<u>\$(3,537,106)</u>	<u>\$(1,203,881)</u>	<u>\$ 104,429</u>		<u>\$ 22,044,127</u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	Year ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net loss	(9,008,274)	(18,504,358)	(17,286,788)
Less loss (profit) for the period from discontinued operations	(110,410)	13,566,206	13,260,999
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minority interest in earnings (loss) of subsidiary	(156,900)	355,360	—
Depreciation	730,159	473,739	530,013
Amortization of intangible assets	864,910	623,543	—
In-process research and development write-off	—	26,000	—
Accrued severance pay, net	3,693	(357,808)	530,777
Amortization of deferred stock compensation	8,286	6,000	17,240
Impairment and write-off of loans to shareholders	(12,519)	542,317	206,005
Compensation expenses related to repurchase of treasury stock		—	228,674
Write-off of inventories	96,350	116,008	—
Impairment of fixed assets	68,945	—	—
Amortization of compensation related to beneficial conversion feature and warrants issued to holders of convertible debentures	3,359,987	—	—
Amortization of deferred expenses related to convertible debenture issuance	483,713	—	—
Amortization of prepaid financial expenses	236,250	—	—
Amortization of capitalized research and development projects	14,401	—	—
Stock-based compensation related to repricing of warrants granted to investors and the grant of new warrants	388,403	—	—
Stock-based compensation related to repricing of warrants granted to consultants	29,759	—	—
Stock-based compensation related to shares issued to consultants	161,947	—	—
Stock-based compensation related to non-recourse note granted to stockholder	38,500	—	—
Compensation expenses related to shares issued to employees	—	13,000	—
Accrued interest on notes receivable from shareholders	—	—	36,940
Interest accrued on promissory notes due to acquisition	(66,793)	29,829	—
Interest accrued on restricted collateral deposit	—	(3,213)	—
Capital (gain) loss from sale of property and equipment	(11,504)	(4,444)	815
Decrease (increase) in trade receivables	(820,137)	389,516	(452,425)
Decrease in other accounts receivable and prepaid expenses	40,520	257,218	616,040
Increase in inventories	(193,222)	(520,408)	(128,897)
Decrease in trade payables	(986,022)	(62,536)	(301,075)
Increase (decrease) in other accounts payable and accrued expenses	1,827,668	(423,664)	286,511
Net cash used in operating activities from continuing operations (reconciled from continuing operations)	(3,012,290)	(3,477,695)	(2,455,171)
Net cash used in operating activities from discontinued operations (reconciled from discontinued operations)	(313,454)	(5,456,912)	(10,894,660)
Net cash used in operating activities	(3,325,744)	(8,934,607)	(13,349,831)

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	Year ended December 31,		
	2003	2002	2001
Cash flows from investing activities:			
Purchase of property and equipment	(580,949)	(275,540)	(513,746)
Increase in capitalized research and development projects	(209,616)	-	-
Payment to suppliers for purchase of property and equipment from previous year	-	(39,336)	(43,883)
Loans granted to shareholders	(13,737)	(4,529)	-
Repayment of loans granted to shareholders	9,280	-	-
Proceeds from sale of property and equipment	16,753	8,199	40,217
Acquisition of IES (1)	-	(2,958,083)	-
Acquisition of MDT (2)	-	(1,201,843)	-
Repayment of promissory note related to acquisition of subsidiary	(750,000)	-	-
Purchase of intangible assets and inventory	(196,331)	-	-
Increase in restricted cash	(72,840)	(595,341)	-
Net cash used in discontinued operations (purchase of property and equipment)	-	(290,650)	(761,555)
Net cash used in investing activities	<u>(1,797,440)</u>	<u>(5,357,123)</u>	<u>(1,278,967)</u>
Cash flows from financing activities:			
Proceeds from issuance of shares, net	(6,900)	3,230,000	14,393,346
Proceeds from exercise of options to employees and consultants	440,914	113,350	470,981
Proceeds from exercise of warrants	3,296,254	-	840,000
Proceeds from the sale of convertible debentures, net	13,708,662	-	-
Payment of interest and principal on notes receivable from shareholders	-	43,308	-
Profit distribution to minority	-	(412,231)	-
Increase (decrease) in short term bank credit	(74,158)	108,659	-
Payment on capital lease obligation	(4,427)	(5,584)	-
Net cash provided by financing activities	<u>17,360,345</u>	<u>3,077,502</u>	<u>15,704,327</u>
Increase (decrease) in cash and cash equivalents	12,237,161	(11,214,228)	1,075,529
Cash erosion due to exchange rate differences	(9,562)	-	-
Cash and cash equivalents at the beginning of the year	1,457,526	12,671,754	11,596,225
Cash and cash equivalents at the end of the year	<u>\$ 13,685,125</u>	<u>\$ 1,457,526</u>	<u>\$ 12,671,754</u>
Supplementary information on non-cash transactions:			
Purchase of property and equipment against trade payables	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 39,336</u>
Purchase of treasury stock in respect of notes receivable from shareholders	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,499,375</u>
Retirement of shares issued under notes receivables	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 18,000</u>
Issuance of shares to consultants in respect of prepaid interest expenses	<u>\$ -</u>	<u>\$ 236,250</u>	<u>\$ -</u>
Exercise of options against notes receivable	<u>\$ -</u>	<u>\$ 36,500</u>	<u>\$ 43,308</u>
Purchase of intangible assets against note receivable	<u>\$ 300,000</u>	<u>\$ -</u>	<u>\$ -</u>
Increase of investment in subsidiary against issuance of shares of common stock	<u>\$ 123,480</u>	<u>\$ -</u>	<u>\$ -</u>
Conversion of promissory note to shares of common stock	<u>\$ 450,000</u>	<u>\$ -</u>	<u>\$ -</u>
Conversion of convertible debenture to shares of common stock	<u>\$ 6,125,000</u>	<u>\$ -</u>	<u>\$ -</u>
Benefit due to convertible debentures and warrants	<u>\$ 10,853,043</u>	<u>\$ -</u>	<u>\$ -</u>
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	<u>\$ 39,412</u>	<u>\$ 10,640</u>	<u>\$ 19,106</u>

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

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

In U.S. dollars

- (1) In 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	\$ 1,233,000
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	<u>4,032,726</u>
	8,298,976
Issuance of shares	(3,653,929)
Issuance of promissory note	<u>(1,686,964)</u>
	<u><u>\$ 2,958,083</u></u>

- (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	<u>886,255</u>
	1,640,920
Issuance of shares	<u>(439,077)</u>
	<u><u>\$ 1,201,843</u></u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

NOTE 1:- GENERAL

a. Arotech Corporation, f/k/a Electric Fuel Corporation (“Arotech” 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 subsidiary; IES Interactive Training, Inc. (“IES”), a wholly-owned U.S. subsidiary; Arocon Security Corporation, a wholly-owned U.S. subsidiary; Electric Fuel Battery Corporation, a wholly-owned U.S. subsidiary; MDT Protective Industries (“MDT”), an Israeli subsidiary in which the Company has a 75.5% interest; and MDT Armor Corporation, a U.S. subsidiary in which the Company has an 88% interest. The Company’s production and research and development operations are primarily located in Israel and in the United States.

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. 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 as 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 conduct 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 our 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 Arotech’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 \$8,354,893 (including \$14,000 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, Arotech has allocated the total cost of the acquisition to IES’s assets as follows:

Tangible assets acquired	\$ 2,856,951
Intangible assets	
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	4,032,726
Liabilities assumed	<u>(1,186,784)</u>
Total consideration	<u>\$ 8,354,893</u>

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

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

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 estimation made by the independent appraisal 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 IES's products; most present customers are expected to purchase add-ons or up-upgrades to their IES simulator systems in the future, and some will purchase additional warranties for the systems they possess. Independent appraisal has therefore valued the Company's customer list using the Income Approach.
5. The value assigned to the trademarks 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.

In September 2003, the Company's IES subsidiary purchased selected assets of Bristlecone Corporation. The assets purchased consisted of inventories, customer lists, and certain other assets (including intangible assets such as intellectual property and customer lists), including the name "Bristlecone Training Products" and the patents for the Heads Up Display (HUD) and a remote trigger device, used by Bristlecone in connection with its designing and manufacturing firearms training devices, for a total consideration of \$183,688 in cash and \$300,000 in promissory notes, payable in four equal semi-annual payments of \$75,000 each, to become due and payable on March 1, 2004, August 31, 2004, February 28, 2005 and August 31, 2005. The acquired patents are used in the IES's Range FDU (firearm diagnostics unit).

The purchase consideration was estimated as follows:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

	<u>U.S. Dollars</u>
Cash consideration	\$ 183,688
Present value of promissory notes	289,333
Transaction expenses	12,643
Total consideration	<u>\$ 485,664</u>

Based upon a valuation of tangible and intangible assets acquired, the Company has allocated the total cost of the acquisition of Bristlecone's assets as follows:

	<u>U.S. Dollars</u>
Tangible assets acquired	\$ 33,668
Intangible assets	
Technology and patents	436,746
Customer list	15,250
Total consideration	<u>\$ 485,664</u>

The Company believes that the acquisition of Bristlecone is not material to its business.

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. The Acquisition was accounted under the purchase method 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 Arotech's Common stock over the period including two days before and after the terms of the acquisition were agreed to and announced.

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

Tangible assets acquired	\$ 1,337,048
Intangible assets	
Technology (five year weighted average useful life)	280,000
Customer base (five year weighted average useful life)	285,000
Goodwill	886,255
Liabilities assumed	<u>(1,020,426)</u>
Total consideration	<u>\$ 1,767,877</u>

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

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

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 by the independent appraisal 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.
3. The value assigned to the customer base is amounted to \$285,000. Independent appraisal has valued the Company's customer base 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 defense sector and usually have longstanding relationships and tend to reorder from the Company.

In September 2003, the Company increased its holdings in both of its vehicle armoring subsidiaries. The Company now holds 88% of MDT Armor Corporation (compared to 76% before this

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

transaction) and 75.5% of MDT Protective Industries Ltd. (compared to 51% before this transaction). The Company acquired the additional stake in MDT from AGA Means of Protection and Commerce Ltd. in exchange for the issuance to AGA of 126,000 shares of its common stock, valued at \$0.98 per share based on the closing price of the Company's common stock on the closing date of September 4, 2003, or a total of \$123,480. Of this amount, a total of \$75,941 was allocated to intangible assets. The Company did not obtain a valuation due to the immaterial nature of this acquisition.

d. Pro forma results:

The following unaudited pro forma 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.

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

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 operation and disposed of all assets related to this segment by an abandonment. The operations and cash flows of consumer battery business have been eliminated from the operations of the entity as a result of the disposal transactions. The Company has no

intent of continuing 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 sums, by the end of the fourth quarter of 2002, and (ii) disposal of the raw materials, equipment and inventory used exclusively in the consumer battery business, since the Company has no reasonable expectation of being able to sell such raw materials, equipment or inventory for any sum 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, other income and expense of the retail sales of consumer battery products business unit for 2002 and 2001 have been reclassified in the accompanying statements of operations as a discontinued operation. 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 operation 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-down of inventory and net property and equipment of the retail sales of consumer battery products business, as follows:

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

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 Ac-

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

counting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") such assets was considered to be impaired, the impairment to be recognized was measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

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, 2003, 2002 and 2001 are as follows:

	Year Ended December 31,		
	2003	2002	2001
Revenues	\$ 117,267	\$ 1,100,442	\$ 1,939,256
Cost of sales ⁽¹⁾	–	(5,293,120)	(5,060,966)
Gross loss	117,267	(4,192,678)	(3,121,710)
Operating expenses	6,857	4,926,844	10,139,289
Impairment of fixed assets	–	4,446,684	–
Operating loss	\$ 110,410	\$(13,566,206)	\$(13,260,999)

⁽¹⁾ Including write-off of inventory in the amount of \$0, \$2,611,000 and \$441,000 for the years ended December 31, 2003, 2002 and 2001.

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

The majority of 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 weighted 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 2003, the Company wrote off \$96,350 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.

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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 2003, 2002 and 2001).

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

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 are

amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142. Intangible assets are amortized over their useful life (See Note 1b. and c).

i. Impairment of indefinite-lived intangible asset

The acquired IES 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 is tested annually for impairment in accordance FAS 142.

j. Impairment of long-lived assets:

The Company and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2003 no impairment losses have been identified.

k. 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 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 SEC Staff Accounting Bulletin No. 104, "Revenue Rec-

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

ognition" ("SAB No. 104") when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probably, and no further obligation remains.

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, 2003, no such estimated losses were identified.

Deferred warranty 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, 2003, 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.

Revenues from products not delivered upon customers' request due to lack of storage space at the customers' facilities during the integration are recognized when the criteria of Staff Accounting Bulletin No. 104 ("SAB No. 104") for bill-and-hold transactions are met.

I. Research and development cost:

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

Significant software development costs incurred by the Company's subsidiaries between completion of the working model and the point at which the product is ready for general release, are capitalized.

Capitalized software costs are amortized by using the straight-line method over the estimated useful life of the product (three to five years). The Company assesses the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through future gross revenues from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2003.

m. 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. Bi-national 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.

n. 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.

o. 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 and trade receivables. Cash and cash equivalents are invested in U.S. dollar deposits with major Israeli and U.S. banks. Such deposits in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

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In U.S. Dollars

The trade receivables of the Company and its subsidiaries are mainly derived from sales to customers located primarily in the United States, Europe and Israel. Management believes that credit risks are moderated by the diversity of its end customers and geographical sales areas. The Company performs ongoing credit evaluations of its customers' financial condition. An allowance for doubtful accounts is determined with respect to those accounts that the Company has determined to be doubtful of collection.

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

p. 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 22,194,211 and 4,394,803 and 3,170,334 for the years ended December 31, 2003, 2002 and 2001, respectively.

q. 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 net income per share is required, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123.

The Company applies SFAS No. 123 and Emerging Issue Task Force No. 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

The fair value for the options to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 2.54%, 3.5% and 3.5-4.5% for 2003, 2002 and 2001, 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 0.67 for 2003, 0.64 for 2002 and 0.82 for 2001; and a weighted-average expected life of the option of 5 years for 2003, 2002 and 2001.

The following table illustrates the effect on net income and earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS No. 123 on its stock-based employee compensation:

	Year Ended December 31,		
	2003	2002	2001
Net income as reported	\$ (9,008,274)	\$ (18,504,358)	\$ (18,483,455)
Add: Stock-based compensation expenses included in reported net loss	8,286	6,000	17,240
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(1,237,558)	(2,072,903)	(2,906,386)
	<u>\$ (10,237,546)</u>	<u>\$ (20,571,261)</u>	<u>\$ (21,372,601)</u>
Loss per share:			
Basic and diluted, as reported	<u>\$ (0.23)</u>	<u>\$ (0.57)</u>	<u>\$ (0.76)</u>
Diluted, pro forma	<u>\$ (0.26)</u>	<u>\$ (0.64)</u>	<u>\$ (0.88)</u>

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r. 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.

Long-term 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.

s. 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, 2003 and 2002, the accumulated severance pay in that regard amounted to \$ 1,699,260 and \$1,630,366, 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 expenses for the year ended December 31, 2003 amounted to \$ 219,857 as compared to severance income and expenses for the years ended December 31, 2002 and 2001, which amounted to \$338,574 and \$653,885, respectively.

t. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2003, 2002 and 2001 was approximately \$34,732, \$294,599 and \$1,676,280 respectively.

NOTE 3:- RESTRICTED COLLATERAL DEPOSIT AND OTHER RESTRICTED CASH

The restricted collateral deposit is invested in a \$706,180 certificate of deposit that is used to secure certain real property lease arrangements, and a currency hedging arrangement to protect the Company against change in the euro versus the dollar in connection with IES's contract with the German police, which is denominated in euros; a portion was also on deposit with an arbitrator in connection with the Company's litigation with IES Electronic Industries, Ltd.

	December 31, 2003
IES Deposit	\$ 450,000
Forward Deal	205,489
Property Lease	41,412
Other	9,279
	<u>\$ 706,180</u>

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NOTE 4:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2003	2002
	U.S. dollars	
Government authorities	\$ 65,402	\$ 348,660
Employees	246,004	23,959
Prepaid expenses	551,010	591,008
Other	324,955	68,684
	<u>\$ 1,187,371</u>	<u>\$ 1,032,311</u>

NOTE 5:– INVENTORIES

	December 31,	
	2003	2002
	U.S. dollars	
Raw and packaging materials	\$ 657,677	\$ 893,666
Work in progress	643,221	296,692
Finished products	622,850	521,121
	<u>\$ 1,914,758</u>	<u>\$ 1,711,479</u>

NOTE 6:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2003	2002
	U.S. dollars	
Cost:		
Computers and related equipment	\$ 1,015,836	\$ 815,759
Motor vehicles	288,852	335,286
Office furniture and equipment	402,726	519,092
Machinery, equipment and installations	4,866,904	4,715,182
Leasehold improvements	882,047	442,482
Demo inventory	150,996	154,689
	<u>7,607,361</u>	<u>6,982,490</u>
Accumulated depreciation:		
Computers and related equipment	753,593	669,258
Motor vehicles	95,434	39,281
Office furniture and equipment	173,301	255,829
Machinery, equipment and installations	3,637,111	3,106,389
Leasehold improvements	655,181	356,484
	<u>5,314,620</u>	<u>4,427,241</u>
Depreciated cost	<u>\$ 2,292,741</u>	<u>\$ 2,555,249</u>

b. Depreciation expense amounted to \$730,159, \$473,739 and \$530,013, for the years ended December 31, 2003, 2002 and 2001, respectively.

As for liens, see Note 10.d.

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NOTE 7:- OTHER INTANGIBLE ASSETS, NET

a.

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

b. Amortization expenses amounted to \$879,311 for the year ended December 31, 2003.

c. Estimated amortization expenses for the years ended:

Year ended December 31,	
2004	\$ 552,443
2005	541,466
2006	366,421
2007	244,734
2008 and forward	231,131
	<u>\$1,936,195</u>

NOTE 8:- 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 treated as changed or modified when 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. The \$450,000 note due at the end of June 2004 was converted into an aggregate of 563,971 shares of common stock in August 2003. With reference to the \$450,000 note due at the end of December 2003, see Note 17.f.

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NOTE 9:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2003	2002
	U.S. dollars	
Employees and payroll accruals	\$ 1,232,608	\$ 615,292
Accrued vacation pay	216,768	137,179
Accrued expenses	842,760	342,793
Minority balance	149,441	289,451
Government authorities	357,095	497,428
Deferred warranty revenues	40,936	95,831
Litigation settlement accrual ⁽¹⁾	1,313,642	–
Other	168,097	31,135
	<u>\$ 4,321,347</u>	<u>\$ 2,009,109</u>

⁽¹⁾ See Note 17.f.

NOTE 10:– 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, 2003, 2002 and 2001, to the OCS amounted to \$435, \$32,801 and \$75,791, respectively.

As of December 31, 2003, the total contingent liability to the OCS was approximately \$10,057,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

2. EFL, in cooperation with a U.S. participant, has received approval from the 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.

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2003.

As of December 31, 2003, the total contingent liability to pay BIRD-F (150%) was approximately \$772,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

b. Lease commitments:

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

<u>Year ended December 31,</u>	
2004	\$ 393,512
2005	197,266
	<u>\$ 590,778</u>

Total rent expenses for the years ended December 31, 2003, 2002 and 2001, were approximately \$484,361, \$629,101 and \$456,701, respectively.

c. Guarantees:

The Company obtained bank guarantees in the amount of \$51,082 in connection with (i) a lease agreement of one of the Company's subsidiaries, (ii) a sales obligation to a customer of one of the

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Company's subsidiaries, and (iii) obligations of one of the Company's subsidiaries to the Israeli customs authorities.

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.

The Company has granted to the holders of its 8% secured convertible debentures a first position security interest in (i) the shares of MDT Armor Corporation, (ii) the assets of its IES Interactive Training, Inc. subsidiary, (iii) the shares of all of its subsidiaries, and (iv) any shares that the Company acquires in future Acquisitions (as defined in the securities purchase agreement).

EFL has granted to its former CEO a security interest in certain of its property located in Beit Shemesh, Israel, to secure sums due to him pursuant to the terms of the settlement agreement with him.

NOTE 11:– 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. 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 11.f.1 and 11.f.2.)

2. 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.

3. 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.

4. 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 11.f.3).

5. 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. 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.

2. 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.

3. On February 15, 2002 and September 10, 2002, the Company issued 318,468 and 50,000 shares, respectively, of common stock 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.

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4. On September 10, 2002, the Company issued an aggregate of 13,000 shares of common stock at par consideration to two of its 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.

5. In July 2003, the Company issued 215,294 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$154,331 in accordance with EITF 96-18. In accordance with EITF 00-18, the Company recorded this compensation expense of \$154,331 during the year 2003 and included this amount in marketing expenses.

6. In November 2003, the Company issued 8,306 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$7,616 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of \$7,616 during the year 2003 and included this amount in marketing expenses.

d. Issuance of shares to lenders

As part of the securities purchase agreement on December 31, 2002 (see Note 16.a), the Company issued 387,301 shares at par as consideration to lenders for the first nine months of interest expenses. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the interest and amounted to \$236,250 in accordance with APB 14. During 2003 the company recorded this amount as financial expenses.

e. Issuance of notes receivable:

1. As part of its purchase of the assets of IES Interactive Training, Inc. (see Note 1.b.), the Company issued a \$450,000 convertible promissory note (see Note 8). This note was converted into an aggregate of 563,971 shares of common stock in August 2003.

f. Warrants:

1. As part of an investment agreement in November 2000, 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 11.b.1), 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.

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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.

2. As part of the investment agreement in May 2001 (see Note 11.b.1), the Company issued to the investors a total of 2,696,971 warrants (the "May 2001 Warrants") to purchase shares of common stock at a price of \$3.22 per share; these warrants are exercisable by the holder at any time after 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.

In June 2003, the Company adjusted the purchase price of 1,357,577 of the May 2001 Warrants to \$0.82 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 905,052 shares of common stock at a purchase price of \$1.45 per share (the "June 2003 Warrants"). The June 2003 Warrants were originally exercisable at any time from and after December 31, 2003 to June 30, 2008; however, in September 2003, the exercise period of 638,385 of these June 2003 Warrants was adjusted to make them exercisable at any time from and after December 31, 2004 to June 30, 2009. As a result the company

recorded during 2003 an expense of \$244,810 and included this amount in general and administrative expenses.

In addition, with respect to an additional 387,879 May 2001 Warrants, in December 2003 the Company adjusted the purchase price to \$1.60 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 193,940 shares of common stock at a purchase price of \$2.25 per share. As a result the company recorded during 2003 an expense of \$74,384 and included this amount in general and administrative expenses.

Additionally, in October 2003 the Company granted to three of these investors additional new warrants to purchase a total of 150,000 shares of common stock at a purchase price of \$1.20 per share. As a result the company recorded during 2003 an expense of \$69,209 and included this amount in general and administrative expenses.

3. As part of the investment agreement in January 2002 (see Note 11.b.4), 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.

4. As part of the securities purchase agreement on December 31, 2002 (see Note 16.a), the Company issued to the purchasers of its 9% secured convertible debentures due June 30, 2005, warrants, as follows: (i) Series A Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of \$0.84 per share; (ii) Series B Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of \$0.89 per share; and (iii) Series C Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of \$0.93 per share. The exercise price of these warrants was adjusted to \$0.64 per share in April 2003.

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In connection with these warrants, the Company recorded a deferred debt discount of \$1,290,000, which will be amortized ratably over the life of the convertible debentures (3 years), unless these warrants are exercised, in which case any remaining financial expense will be taken in the quarter in which the exercise occurs. This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of 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.

During 2003, an aggregate of 1,500,042 shares were issued pursuant to exercises of these warrants.

During 2003, the Company recorded an expense of \$847,714, of which \$423,857 was attributable to amortization of the convertible debentures over their term and \$423,857 was attributable to accelerated amortization due to the exercise of warrants. Those expenses were included in the financial expenses.

5. As part of the securities purchase agreement on September 30, 2003 (see Note 16.b), the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 1,250,000 shares of common stock at any time prior to September 30, 2006 at a price of \$1.4375 per share.

In connection with these warrants, the Company recorded a deferred debt discount of \$1,025,000, 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" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 1.95%, a volatility factor 98%, dividend yields of 0% and a contractual life of 3 years.

During 2003, an aggregate of 437,500 shares were issued pursuant to exercises of these warrants.

During 2003 the Company recorded an expense of \$414,676, of which \$78,512 was attributable to amortization of the debt discount over their term and \$336,164 was attributable to amortization due to accelerated exercise of warrants. Those expenses were included in the financial expenses.

6. As a further part of the securities purchase agreement on September 30, 2003 (see Note 16.c), the Company issued to the purchasers of its 8% secured convertible debentures due December 31, 2006, warrants to purchase an aggregate of 1,500,000 shares of common stock at any time prior to December 31, 2006 at a price of \$1.8125 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 1,038,000 shares of common stock at any time prior to December 31, 2006 at a price of \$2.20 per share.

In connection with these warrants, the Company will record financial expenses of \$ 1,545,000 and \$1,297,500 for the additional and the supplemental warrants referred to above, respectively, 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" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.45%, a volatility factor 98%, dividend yields of 0% and a contractual life of 3 years.

During 2003 the Company recorded an expense of \$53,440 for amortization of these debt discounts over their term, which is included in financial expenses.

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 53,592 were available for future grants to employees as of December 31, 2003.

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2) 1993 Employee Option Plan – as amended, 6,200,000 shares reserved for issuance, of which no shares were available for future grants to employees as of December 31, 2003.

3) 1998 Employee Option Plan – as amended, 4,750,000 shares reserved for issuance, of which no shares were available for future grants to employees and consultants as of December 31, 2003.

4) 1995 Non-Employee Director Plan – 1,000,000 shares reserved for issuance, of which 600,000 were available for future grants to directors as of December 31, 2003.

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, 2003, 2002 and 2001, and changes during the years ended on those dates, is presented below:

	2003		2002		2001	
	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$
Options outstanding at beginning of year	5,260,366	\$ 2.26	4,240,228	\$ 2.74	2,624,225	\$ 3.82
Changes during year:						
Granted (1) (2)	5,264,260	\$ 0.71	1,634,567	\$ 0.87	2,172,314	\$ 1.55
Exercised (3)	689,640	\$ 0.64	(191,542)	\$ 1.29	(159,965)	\$ 1.31
Forfeited or cancelled	(816,675)	\$ 3.51	(422,887)	\$ 1.92	(396,346)	\$ 4.11
Options outstanding at end of year	<u>9,018,311</u>	<u>\$ 1.37</u>	<u>5,260,366</u>	<u>\$ 2.26</u>	<u>4,240,228</u>	<u>\$ 2.74</u>
Options exercisable at end of year	<u>5,826,539</u>	<u>\$ 1.70</u>	<u>4,675,443</u>	<u>\$ 2.26</u>	<u>2,643,987</u>	<u>\$ 2.75</u>

(1) Includes 2,035,000, 481,435 and 1,189,749 options granted to related parties in 2003, 2002 and 2001, respectively.

(2) 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 \$4,750, \$0 and \$18,000 as of December 31, 2003, 2002 and 2001, 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 and directors in 2003, 2002 and 2001, was \$8,286, \$6,000 and \$17,240, respectively.

(3) In June 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. During the year 2003, the company recorded compensation in amount of \$38,500 due to increase in the market value of the company's shares.

d. The options outstanding as of December 31, 2003 have been separated into ranges of exercise price, as follows:

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Range of exercise prices	Total options outstanding			Exercisable options outstanding	
	Amount outstanding at December 31, 2003	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2003	Weighted average exercise price
	\$	Years	\$	\$	\$
0.01-2.00	7,773,767	7.48	0.90	4,584,740	0.98
2.01-4.00	314,544	3.56	3.07	314,544	3.07
4.01-6.00	885,000	6.28	4.60	882,255	4.60
6.01-8.00	35,000	2.05	7.73	35,000	7.73
8.01	10,000	3.75	9.06	10,000	9.06
	<u>9,018,311</u>	<u>7.20</u>	<u>1.37</u>	<u>5,826,539</u>	<u>1.70</u>

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,		
	2003	2002	2001	2003	2002	2001	2003	2002	2001
Weighted average exercise prices	\$ 0.950	\$ 1.265	\$ 1.579	\$ -	\$ -	\$ 1.466	\$ -	\$ 0.755	\$ 1.300
Weighted average fair value on grant date	\$ 0.730	\$ 0.560	\$ 0.500	\$ -	\$ -	\$ 0.560	\$ -	\$ 0.250	\$ 0.790

2. Options issued to consultants:

a. The Company's outstanding options to consultants as of December 31, 2003, are as follows:

	2003		2002		2001	
	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	245,786	\$ 5.55	175,786	\$ 6.57
Changes during year:						
Granted (1)	83,115	\$ 0.99	-	-	130,000	\$ 6.02
Exercised	(15,000)	\$ 0.49	-	-	(60,000)	\$ 5.13
Repriced (2):						
Old exercise price	-	-	-	-	(56,821)	\$ 9.44
New exercise price	-	-	-	-	56,821	\$ 4.78
Options outstanding at end of year	<u>313,901</u>	<u>\$ 4.59</u>	<u>245,786</u>	<u>\$ 5.55</u>	<u>245,786</u>	<u>\$ 5.55</u>
Options exercisable at end of year	<u>193,901</u>	<u>\$ 3.46</u>	<u>125,786</u>	<u>\$ 6.42</u>	<u>125,786</u>	<u>\$ 6.42</u>

(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.

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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:

	2003	2002	2001
Dividend yield	0%	-	0%
Expected volatility	78%	-	82%
Risk-free interest	2.3%	-	3.5-4.5%
Expected life of up to	10 years	-	10 years

c. In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling \$29,759, \$0 and \$139,291 for the years ended December 31, 2003, 2002 and 2001, respectively, and included these amounts in marketing and general and administrative expenses.

3. Dividends:

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

4. Treasury Stock:

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

h. Issuances in connection with acquisitions:

In September 2003, the Company acquired an additional 12% interest in MDT Armor Corporation and an additional 24.5% interest in MDT Protective Industries Ltd. in exchange for the issuance to AGA Means of Protection and Commerce Ltd. of 126,000 shares of its common stock.

NOTE 12:- INCOME TAXES

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

As of December 31, 2003, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$17.0 million, which are available to offset future taxable income, if any, expiring in 2010 through 2022. Utilization of U.S net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in

the expiration of net operating losses before utilization.

b. Israeli subsidiary (EFL):

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

A small part of 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.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the Company they would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative system of benefits, currently between 25% for an "Approved Enterprise." As of December 31, 2003, the accumulated deficit of the Company does not include tax-exempt profits earned by the Company's "Approved Enterprise."

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, 2003, according to the Company's management, the Company has fulfilled all conditions.

The main tax benefits available to EFL are:

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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. 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.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 36%.

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 difference 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 loss carryforwards:

As of December 31, 2003, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$84.0 million, which are available, indefinitely, to offset future taxable income.

c. 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,	
	2003	2002
	U.S. dollars	
Operating loss carryforward	\$ 33,958,434	\$ 29,257,118
Reserve and allowance	843,453	303,204
Net deferred tax asset before valuation allowance	34,801,887	29,560,322
Valuation allowance	(34,801,887)	(29,560,322)
	<u>\$ -</u>	<u>\$ -</u>

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 differ-

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ences will not be realized. The change in the valuation allowance as of December 31, 2003 was \$5,241,565.

d. Loss from continuing operations before taxes on income and minority interest in loss (earnings) of a subsidiary:

	Year ended December 31		
	2003	2002	2001
Domestic	\$ (7,181,774)	\$ (5,250,633)	\$ (5,828,828)
Foreign	(1,697,617)	(13,254,195)	(11,457,960)
	<u>\$ (8,879,391)</u>	<u>\$ (18,504,358)</u>	<u>\$ (17,286,788)</u>

e. Taxes on income were comprised of the following:

	Year ended December 31		
	2003	2002	2001
Current taxes	\$ 44,102	\$ -	\$ -
Taxes in respect of prior years	352,091	-	-
	<u>\$ 396,193</u>	<u>\$ -</u>	<u>\$ -</u>
Domestic	\$ 33,020	\$ -	\$ -
Foreign	363,173	-	-
	<u>\$ 396,193</u>	<u>\$ -</u>	<u>\$ -</u>

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

	Year ended December 31,		
	2003	2002	2001
Loss from continuing operations before taxes, as reported in the consolidated statements of income	<u>\$(8,879,391)</u>	<u>\$(4,582,792)</u>	<u>\$(4,025,789)</u>
Statutory tax rate	35%	35%	35%
Theoretical tax income on the above amount at the U.S. statutory tax rate	\$(3,107,787)	\$(1,603,977)	\$(1,409,026)
Deferred taxes on losses for which valuation allowance was not provided	1,178,215	1,603,977	1,409,026
Non-deductible expenses	1,940,019	-	-
State taxes	33,020	-	-
Other	635	-	-
Taxes in respect of prior years due to change in estimates	352,091	-	-
Actual tax expense	<u>\$ 396,193</u>	<u>\$ -</u>	<u>\$ -</u>

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NOTE 13:– SELECTED STATEMENTS OF OPERATIONS DATA

Financial income, net:

	Year ended December 31,		
	2003	2002	2001
Financial expenses:			
Interest, bank charges and fees	\$ (355,111)	\$ (89,271)	\$ (49,246)
Amortization of compensation related to beneficial convertible feature of convertible debenture and warrants issued to the holders of convertible debenture	(3,359,987)	–	–
Foreign currency translation differences	115,538	15,202	(16,003)
	<u>(3,599,560)</u>	<u>(74,069)</u>	<u>(65,249)</u>
Financial income:			
Interest	129,101	174,520	327,830
Total	<u>\$ (3,470,459)</u>	<u>\$ 100,451</u>	<u>\$ 262,581</u>

NOTE 14:– RELATED PARTY DISCLOSURES

	Year ended December 31,		
	2003	2002	2001
	U.S. dollars		
Transactions:			
Reimbursement of general and administrative expenses	\$ –	\$ 36,000	\$ 23,850
Financial income (expenses), net from notes receivable and loan holders	\$ –	\$ (7,309)	\$ (36,940)

NOTE 15:– 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 re-

classified information previously reported in order to comply with new segment reporting.

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

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

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	<u>Batteries</u>	<u>Defense and Security Products</u>	<u>All Other</u>	<u>Total</u>
2003				
Revenues from outside customers	\$ 5,868,899	\$ 11,457,742	\$ –	\$ 17,326,641
Depreciation expense	(527,775)	(927,665)	(139,630)	(1,595,070)
Direct expenses (1)	(5,945,948)	(10,892,933)	(4,539,674)	(21,378,555)
Segment gross loss	<u>(604,824)</u>	<u>(362,856)</u>	<u>(4,679,304)</u>	<u>(5,646,984)</u>
Financial income net	–	–	–	(3,471,700)
Net loss from continuing operations				<u>(9,118,684)</u>
Segment assets (2)	<u>2,128,062</u>	<u>1,628,562</u>	<u>450,864</u>	<u>4,207,488</u>
Expenditures for segment assets	<u>247,989</u>	<u>208,497</u>	<u>124,463</u>	<u>580,949</u>
2002				
Revenues from outside customers	\$ 1,682,296	\$ 4,724,443	\$ –	\$ 6,406,739
Depreciation expense and amortization	(252,514)	(676,753)	(194,014)	(1,123,281)
Direct expenses (1)	(3,062,548)	(4,353,770)	(2,905,743)	(10,322,061)
Segment gross loss	<u>\$ (1,632,766)</u>	<u>\$ (306,080)</u>	<u>\$ (3,099,757)</u>	<u>(5,038,603)</u>
Financial income				100,451
Net loss from continuing operation				<u>\$ 4,938,152</u>
Segment assets (2)	<u>\$ 2,007,291</u>	<u>\$ 1,683,825</u>	<u>\$ 575,612</u>	<u>\$ 4,266,728</u>
Expenditures for segment assets	<u>\$ 246,664</u>	<u>\$ 58,954</u>	<u>\$ 70,486</u>	<u>\$ 376,104</u>
2001				
Revenues from outside customers	\$ 2,093,632	\$ –	\$ –	\$2,093,632
Depreciation expense	(304,438)	–	(225,577)	(530,015)
Direct expenses (1)	(2,295,501)	–	(3,556,486)	(5,851,987)
Segment gross loss	<u>\$ (506,307)</u>	<u>\$ –</u>	<u>\$ (3,782,063)</u>	<u>(4,288,370)</u>
Financial income net				262,581
Net loss from continuing operations				<u>\$ (4,025,789)</u>
Segment assets (2)	<u>\$ 2,044,257</u>	<u>\$ 1,175,521</u>	<u>\$ 702,915</u>	<u>\$ 2,744,172</u>
Expenditures for segment assets	<u>\$ 229,099</u>	<u>\$ 229,099</u>	<u>\$ 323,985</u>	<u>\$ 553,084</u>

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

(2) Including property and equipment and inventory.

c. Summary information about geographic areas:

The following presents total revenues according to end customers location for the years ended December 31, 2003, 2002 and 2001, and long-lived assets as of December 31, 2003, 2002 and 2001:

	<u>2003</u>		<u>2002</u>		<u>2001</u>	
	<u>Total revenues</u>	<u>Long-lived assets</u>	<u>Total revenues</u>	<u>Long-lived assets</u>	<u>Total revenues</u>	<u>Long-lived assets</u>
	U.S. dollars					
U.S.A.	\$10,099,652	\$ 6,778,050	\$ 2,787,250	\$ 6,710,367	\$ 1,057,939	\$ 60,531
Germany	2,836,725	–	38,160	–	526,766	–
England	29,095	–	47,696	–	36,648	–
Thailand	95,434	–	291,200	–	–	–
Israel	3,576,139	2,954,441	2,799,365	3,367,320	13,773	2,160,275
Other	689,596	–	443,068	–	458,506	–
	<u>\$17,326,641</u>	<u>\$ 9,732,491</u>	<u>\$ 6,406,739</u>	<u>\$10,077,687</u>	<u>\$ 2,093,632</u>	<u>\$ 2,220,806</u>

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d. Revenues from major customers:

	Year ended December 31,		
	2003	2002 %	2001
Electric Fuel Batteries:			
Customer A	—	—	22%
Customer B	2%	7%	20%
Customer C	1%	2%	13%
Customer D	27%	8%	12%
Defense and Security Products:			
Customer A	17%	43%	—
Customer B	16%	—	—

e. Revenues from major products:

	Year ended December 31,		
	2003	2002	2001
EV	\$ 408,161	\$ 460,562	\$ 894,045
WAB	703,084	647,896	951,598
Military batteries	4,757,116	573,839	247,989
Car armoring	3,435,715	2,744,382	—
Interactive use-of-force training	7,961,302	1,980,060	—
Other	61,263	—	—
Total	<u>\$17,326,641</u>	<u>\$6,406,749</u>	<u>\$2,093,632</u>

NOTE 16:— CONVERTIBLE DEBENTURES

a. 9% Secured Convertible Debentures due June 30, 2005

Pursuant to the terms of a Securities Purchase Agreement dated December 31, 2002, the Company issued and sold to a group of institutional investors an aggregate principal amount of 9% secured convertible debentures in the amount of \$3.5 million due June 30, 2005. These debentures are convertible at any time prior to June 30, 2005 at a conversion price of \$0.75 per share, or a maximum aggregate of 4,666,667 shares of common stock (see also Note 11.f.4). The conversion price of these debentures was adjusted to \$0.64 per share in April 2003. In accordance with EITF 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments,” the terms of convertible debentures are not treated as changed or modified when the cash flow effect on a present value basis is less than 10%, and therefore the Company did not record any compensation related to the change in the conversion price of the convertible debentures.

During 2003, an aggregate of \$2,350,000 in 9% secured convertible debentures was converted into an aggregate of 3,671,875 shares of common stock.

In determining whether the convertible debentures include a beneficial conversion feature 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 relative fair values. In connection with these convertible debentures, the Company will record financial expenses of \$600,000 with respect to the beneficial conversion feature. The \$600,000 is amortized from the date of issuance to the stated redemption date – June 30, 2005 – as financial expenses.

During 2003 the Company recorded an expense of \$481,714, of which \$174,000 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$307,714 was attributable to amortization due to conversion of the convertible debenture into shares.

b. 8% Secured Convertible Debentures due September 30, 2006

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of

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8% secured convertible debentures in the amount of \$5.0 million due September 30, 2006. These debentures are convertible at any time prior to September 30, 2006 at a conversion price of \$1.15 per share, or a maximum aggregate of 4,347,826 shares of common stock (see also Note 11.f.5).

During 2003, an aggregate of \$3,775,000 in 8% secured convertible debentures was converted into an aggregate of 3,282,608 shares of common stock.

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 relative fair values. In connection with these convertible debentures, the Company will record financial expenses of \$1,938,043 with respect to the beneficial conversion feature. The \$1,938,043 is amortized from the date of issuance to the stated redemption date – September 30, 2006 – as financial expenses.

During 2003 the Company recorded an expense of \$1,503,080, of which \$134,646 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$1,368,434 was attributable to amortization due to conversion of the convertible debenture into shares.

NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED)

a. Debenture conversion:

In January 2004, a total of \$1,150,000 principal amount of 9% debentures was converted into an aggregate of 1,796,875 shares of common stock at a conversion price of \$0.64 per share.

b. Issuance of common stock to investors:

In January 2004, the Company issued to a group of investors an aggregate of 9,840,426 shares of common stock at a price of \$1.88 per share, or a total purchase price of \$18,500,000. (See also Note 17.c.)

c. Issuance of warrants to investors:

As part of the investment agreement in January 2004 (see Note 17.b.), the Company issued to a group of investors warrants to purchase an aggregate of 9,840,426 shares of common stock at

c. 8% Secured Convertible Debentures due December 31, 2006

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$6.0 million due December 31, 2006. These debentures are convertible at any time prior to December 31, 2006 at a conversion price of \$1.45 per share, or a maximum aggregate of 4,137,931 shares of common stock (see also Note 11.f.6).

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 relative fair values. In connection with these convertible debentures, the Company will record financial expenses of \$3,157,500 with respect to the beneficial conversion feature. The \$3,157,500 is amortized from the date of issuance to the stated redemption date – December 31, 2006 – as financial expenses.

During 2003 the Company recorded an expense of \$59,362, which represents the amortization of the beneficial conversion feature of the convertible debenture over its term.

a price of \$1.88 per share. These warrants are exercisable by the holder at any time after August 12, 2004 and will expire on January 12, 2007.

d. Acquisition of FAAC Incorporated:

In January 2004, the Company purchased all of the outstanding stock of FAAC Incorporated, a Michigan corporation ("FAAC"), from FAAC's existing shareholders. The assets acquired through the purchase of all of FAAC's outstanding stock consisted of all of FAAC's assets, including FAAC's current assets, property and equipment, and other assets (including intangible assets such as goodwill, intellectual property and contractual rights). The consideration for the assets purchased consisted of (i) cash in the amount of \$12,000,000, and (ii) the issuance of \$2,000,000 in Arotech stock, plus an

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. Dollars

earn-out based on 2004 net pretax profit, with an additional earn-out on the 2005 net profit from certain specific and limited programs.

e. Acquisition of Epsilon Electronic Industries, Ltd.:

In January 2004, the Company purchased all of the outstanding stock of Epsilon Electronic Industries, Ltd., an Israeli corporation ("Epsilon"), from Epsilon's existing shareholders. The assets acquired through the purchase of all of Epsilon's outstanding stock consisted of all of Epsilon's assets, including Epsilon's current assets, property and equipment, and other assets (including intangible assets such as goodwill, intellectual property and contractual rights). The consideration for the assets purchased will consist of (i) cash in the amount of \$7,000,000, and (ii) a series of three \$1,000,000 promissory notes, due on the first, second and third anniversaries of the Agreement under the circumstances set forth in the acquisition agreement.

f. Settlement of litigation:

On February 4, 2004, the Company entered into an agreement settling the litigation brought against it in the Tel-Aviv, Israel district court by I.E.S. Electronics Industries, Ltd. ("IES Electron-

ics") and certain of its affiliates in connection with the Company's purchase of the assets of its IES Interactive Training, Inc. subsidiary from IES Electronics in August 2002. The litigation had sought monetary damages in the amount of approximately \$3 million. Pursuant to the terms of the settlement agreement, in addition to agreeing to dismiss their lawsuit with prejudice, IES Electronics agreed (i) to cancel the Company's \$450,000 debt to them that had been due on December 31, 2003, and (ii) to transfer to the Company title to certain certificates of deposit in the approximate principal amount of \$112,000. The parties also agreed to exchange mutual releases. In consideration of the foregoing, the Company issued to IES Electronics (i) 450,000 shares of common stock, and (ii) five-year warrants to purchase up to an additional 450,000 shares of common stock at a purchase price of \$1.91 per share.

In respect of the above settlement, the Company recorded in 2003 an expense of \$838,714, representing the fair value of the warrants and shares over the remaining balance of the Company's debt to IES Electronics as carried in the Company books at December 31, 2003, less the \$112,000 certificate of deposit that was transferred to the Company's name as noted above.

SUPPLEMENTARY FINANCIAL DATA

Quarterly Financial Data (unaudited) for the two years ended December 31, 2003

<u>2003</u>	Quarter Ended			
	March 31	June 30	September 30	December 31
Net revenue.....	\$ 4,033,453	\$ 3,493,135	\$ 5,705,898	\$ 4,094,155
Gross profit.....	\$ 1,399,734	\$ 1,013,965	\$ 2,453,575	\$ 1,371,527
Net loss from continuing operations	\$ (1,291,122)	\$ (2,640,920)	\$ 77,093	\$ (5,263,735)
Net loss from discontinued operations	\$ (95,961)	\$ 179,127	\$ (2,285)	\$ 29,529
Net loss for the period	\$ (1,387,083)	\$ (2,461,793)	\$ 74,808	\$ (5,234,206)
Net loss per share – basic and diluted	\$ (0.04)	\$ (0.07)	\$ 0.00	\$ (0.12)
Shares used in per share calculation	34,758,960	36,209,872	40,371,940	43,604,830

<u>2002</u>	Quarter Ended			
	March 31	June 30	September 30	December 31
Net revenue.....	\$ 570,545	\$ 425,053	\$ 3,262,711	\$ 2,148,430
Gross profit.....	\$ 186,917	\$ 48,807	\$ 1,593,770	\$ 155,497
Net loss from continuing operations	\$ (990,097)	\$ (1,005,877)	\$ (923,122)	\$ (2,019,054)
Net loss from discontinued operations	\$ (2,324,109)	\$ (1,654,108)	\$ (8,716,422)	\$ (871,567)
Net loss for the period	\$ (3,314,208)	\$ (2,659,985)	\$ (9,369,544)	\$ (2,890,621)
Net loss per share – basic and diluted	\$ (0.11)	\$ (0.09)	\$ (0.29)	\$ (0.08)
Shares used in per share calculation	30,149,210	30,963,919	33,441,137	34,758,048

FINANCIAL STATEMENT SCHEDULE
Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2003, 2002 and 2001

Description	Balance at beginning of period	Additions charged to costs and expenses	Balance at end of period
Year ended December 31, 2003			
Allowance for doubtful accounts	\$ 40,636	\$ 20,646	\$ 61,282
Valuation allowance for deferred taxes	29,560,322	5,241,565	34,801,887
Totals	<u>\$ 29,600,958</u>	<u>\$ 5,262,211</u>	<u>\$ 34,863,169</u>
Year ended December 31, 2002			
Allowance for doubtful accounts	\$ 39,153	\$ 1,483	\$ 40,636
Valuation allowance for deferred taxes	12,640,103	16,920,219	29,560,322
Totals	<u>\$ 12,679,256</u>	<u>\$ 16,921,702</u>	<u>\$ 29,600,958</u>
Year ended December 31, 2001			
Allowance for doubtful accounts	\$ 13,600	\$ 25,553	\$ 39,153
Valuation allowance for deferred taxes	8,987,750	3,652,353	12,640,103
Totals	<u>\$ 9,001,350</u>	<u>\$ 3,677,906</u>	<u>\$ 12,679,256</u>

AROTECH DIRECTORS

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

Edward J. Borey, Director
*Former President and Chief Executive Officer,
PSC, Inc.*

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

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

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.*

AROTECH CORPORATE OFFICERS

Robert S. Ehrlich
Chairman, President and CEO

Steven Esses
Executive Vice President and COO

Arik Arad
Executive Vice President

Jonathan Whartman
Senior Vice President

Avihai Shen
Vice President – Finance and CFO

Dr. Neal Naimer
Vice President and Chief Technology Officer

Yaakov Har-Oz
Vice President, General Counsel and Secretary

Danny Waldner
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Monday, June 14, 2004, 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, 59 Maiden Lane, New York, New York 10038.

Shares Traded

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

Independent Auditor

Kost, Forer, Gabbay & Kassierer, 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, 250 West 57th Street, Suite 310, New York, New York 10107.

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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