AROTECH

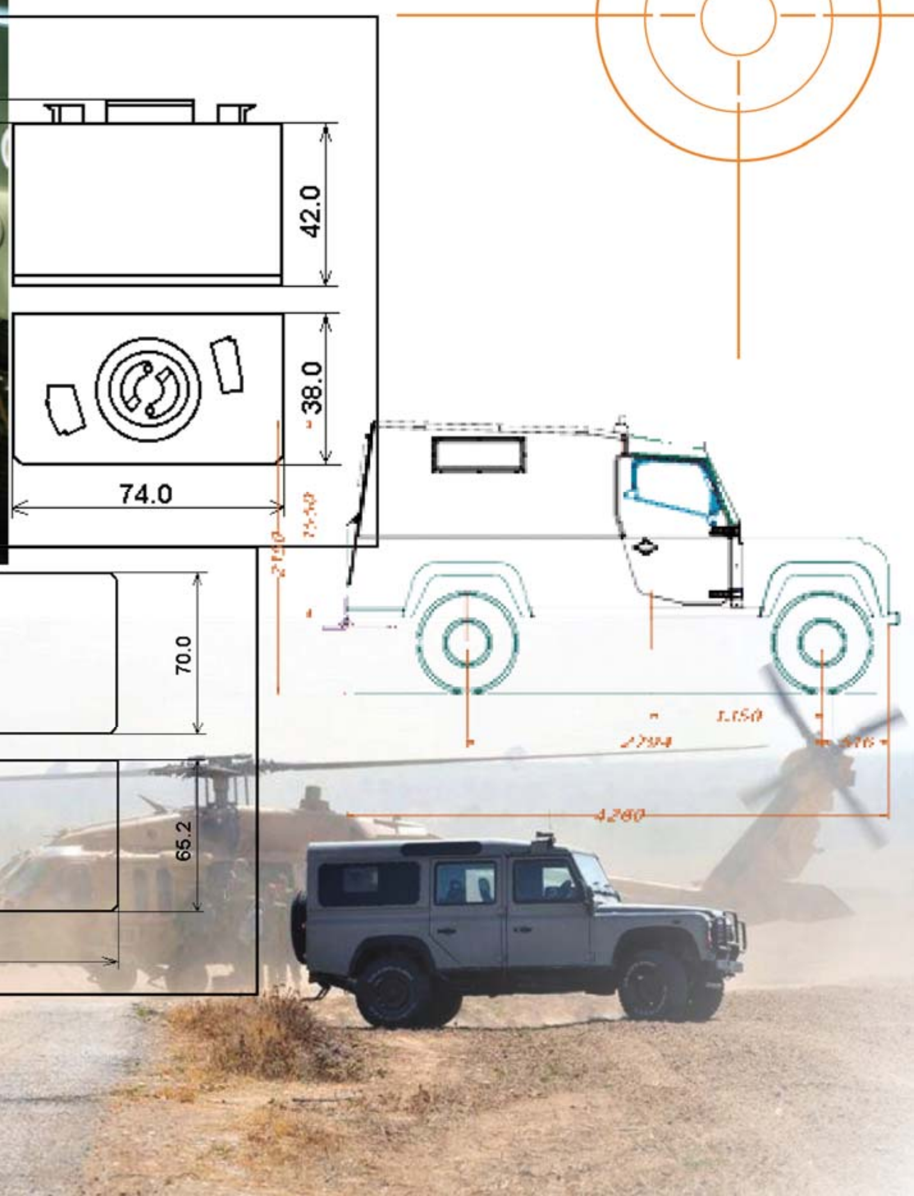
Arotech Corporation Annual Report 2010

Nasdaq: ARTX

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

We Train
We Protect
We Supply

Training & Simulation
Armor
Battery & Power Systems
Divisions



Arotech Corporation

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July 2011

Dear Fellow Shareholder,

2010 was a difficult year for defense companies, but we still managed to come through it relatively unscathed. We were able to come close to matching our 2009 revenues and EBITDA, a significant accomplishment in an environment in which defense orders were being pushed off.

As it turns out, one of these delayed-issuance programs turned out to be the biggest award in our company's history. In April of this year we were awarded the VCTS [virtual convoy training system] in the base amount of $63 million, with options for up to an additional $30 million. This win represents a tribute to the perseverance and aggressiveness of our Simulation group. Not to be outdone, our Battery and Power Systems division began developing a number of new products, some of which are already being tested, which will enhance the division's portfolio of products with higher margin products. Our Soldier Worn Integrated Power Equipment System (SWIPES) is in test with every major branch of the U.S. military, including among others the Navy Seals, the Delta Force and the Army Rangers, as well as the Army, Navy and Marine Corps.

Some of the other developments started in 2010, such as the new submarine battery for the IDF, UAV batteries and missile batteries, are in various stages of development and testing and should result in increasing revenues in 2012 and beyond.

We also participated in a number of shows with Textron Corporation, our teaming partner for sales of our new improved Armored Jeep, the TIGER. The Tiger received enthusiastic reviews from the military and SWAT participants at these events. We anticipate first orders in the second half of this year.

All in all we were satisfied with our performance in 2010 but frustrated that we could not continue our five year growth cycle. Based on our current backlog of over $100,000,000, however, we are confident of that we will return to revenue growth in 2011 and beyond.

Sincerely,

Robert S. Ehrlich
Chairman and Chief Executive Officer

The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on March 30, 2011.

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 and nonmilitary air and ground vehicles. We operate primarily through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned by us) are as follows:

- We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our ***Training and Simulation Division***:
  - We provide simulators, systems engineering and software products to the United States military, government and private industry through our subsidiary FAAC Incorporated, located in Ann Arbor, Michigan ("FAAC"); and
  - Through FAAC, we provide specialized "use of force" training for police, security personnel and the military under the trade name IES Interactive Training ("IES").
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications through our ***Battery and Power Systems Division***:
  - We develop and sell rechargeable and primary lithium batteries and smart chargers to the military and to private defense industry in the Middle East, Europe and Asia through our subsidiary Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area) ("Epsilor");
  - We develop, manufacture and market primary Zinc-Air batteries, rechargeable batteries and battery chargers for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama ("EFB"); and
  - We produce water-activated lifejacket lights for commercial aviation and marine applications through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel ("EFL").
- We utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles and to manufacture personal and aviation armor through our ***Armor Division***:
  - We use state-of-the-art advanced engineering concepts to produce combat armored military vehicles and up-armor civilian commercial vehicles through our subsidiaries MDT Protective Industries, Ltd., located in Lod, Israel ("MDT"), and MDT Armor Corporation, located in Auburn, Alabama ("MDT Armor"); and
  - We use state-of-the-art lightweight armoring materials and advanced engineering processes to provide ballistic armor kits for rotary and fixed wing aircraft under the trade name Armour of America ("AoA").

Background

We were incorporated in Delaware in 1990 under the name "Electric Fuel Corporation," and we changed our name to "Arotech Corporation" on September 17, 2003. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech's wholly-owned Israeli subsidiaries, EFL, Epsilor and MDT; and Arotech's wholly-owned United States subsidiaries, EFB, FAAC and MDT Armor. Additionally, we operate under the trade names of IES Interactive Training (IES), Realtime Technologies, Inc, (RTI) and Armour of America (AoA).

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

Facilities

Our principal executive offices are located at 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our periodic reports, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at http://www.arotech.com/compro/investor.html, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this annual report.

The offices and facilities of three of our principal subsidiaries, EFL, MDT and Epsilor, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of the members of our senior management work extensively out of EFL's facilities; our financial operations are conducted primarily from our principal executive offices in Ann Arbor. FAAC's home offices and facilities are located in Ann Arbor, Michigan and in Royal Oak, Michigan. The facilities of EFB and MDT Armor are located in Auburn, Alabama.

Training and Simulation Division

We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driver training of military, law enforcement, security and other personnel through our Training and Simulation Division, the largest of our three divisions. During 2010 and 2009, revenues from our Training and Simulation Division were approximately $35.6 million and $39.2 million, respectively.

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

- Our *Vehicle Simulation* group provides high fidelity vehicle simulators for use in operator training and is marketed under our FAAC and Realtime Technologies nameplates;
- Our *Military Operations* group provides weapon simulations used to train military pilots in the effective use of air launched weapons and is also marketed under our FAAC nameplate; and
- Our *Use of Force* group provides training products focused on the proper employment of hand carried weapons and is marketed under our IES Interactive Training nameplate.

Vehicle Simulation

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

Our Vehicle Simulation group focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, subway trains, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles. In 2010, our Vehicle Simulations group accounted for approximately 54% of our Training and Simulation Division's revenues.

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

In January of 2008 we added Realtime Technologies Incorporated to our Vehicle Simulation group. RTI specializes in multi-body vehicle dynamics modeling and graphical simulation solutions. RTI offers simulation software applications, consulting services, and custom software and hardware development services primarily for use by the automobile industry and universities engaged in the study of vehicle performance or operator/vehicle interactions. We merged RTI into FAAC in January 2010.

Military Operations

In the area of Military Operations, we believe we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare systems for all branches of the Department of Defense and its related industrial contractors. Our simulations are found in systems ranging from instrumented air combat and maneuver training ranges (such as Top Gun), full task training devices such as the F-18 Weapon Tactics Trainer, and in the on-board computer of many fighter jet aircraft. We supply on-board software to support weapon launch decisions for the F-15, F-16, F-18, F-22 and Joint Strike Fighter (JSF) fighter aircraft. In 2010, our Military Operations group accounted for 24% of our Training and Simulation Division's revenues.

Use-of-Force

We are a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, security, military and similar applications. With a large customer base spread over twenty countries around the world, we are a leader in the supply of simulation training products to law enforcement, governmental, and commercial clients. We conduct our interactive training activities and market our interactive training products, such as the MILO (Multiple Interactive Learning/training Objectives) System, the A2Z Classroom Trainer (a state-of-the-art Computer Based Training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom), and the Range FDU (firearm diagnostics unit), using our IES Interactive Training nameplate. In 2010, our Use of Force group accounted for 22% of our Training and Simulation Division's revenues.

Marketing and Customers

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

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

Competition

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

VEHICLE SIMULATORS

Several potential competitors in this segment are large, diversified defense and aerospace conglomerates who do not focus on our specific niches. As such, we are able to provide service on certain large military contracts through strategic agreements with these organizations or can compete directly with these organizations based on our strength in developing higher quality software solutions. In municipal market applications, we compete against smaller, less sophisticated software companies. Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

MILITARY OPERATIONS

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

USE OF FORCE

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

Battery and Power Systems Division

We manufacture and sell Lithium and Zinc-Air batteries for defense and security products and other military applications through our Battery and Power Systems Division. During 2010 and 2009, revenues from our Battery and Power Systems Division were approximately $18.7 million and $17.8 million, respectively.

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

We sell lithium batteries and charging systems to the military through our subsidiaries Epsilor and EFB.

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

COMPETITION

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

It should be noted that a number of OEMs, such as Motorola, have internal engineering groups that can develop competitive products in-house. Additionally, many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

MARKETING

We market to our existing customers through direct sales. To generate new customers and applications, we rely on our working relationship with a selection of OEMs, with the intent of having these OEMs design our products into their equipment, thereby creating a market with a high entry barrier. Another avenue for market entry is via strategic relationships with major cell manufacturers. We are now starting direct marketing efforts to emerging markets where we believe the number of local mature competitors is limited.

MANUFACTURING

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

Zinc-Air Batteries and Chargers for the Military

INTRODUCTION

We base our strategy in the field of Zinc-Air military batteries on the development and commercialization of our Zinc-Air battery technology, as applied in the batteries we produce for the U.S. Army's Communications and Electronics Command (CECOM) through our subsidiary EFB. We will continue to seek new applications for our technology in defense projects, wherever synergistic technology and business benefits may exist. We intend to continue to develop our battery products for defense agencies, and plan to sell our products either directly to such agencies or through prime contractors. We will also look to extend our reach to military markets outside the United States.

Our batteries have been used in both Afghanistan (Operation Enduring Freedom) and in Iraq (Operation Iraqi Freedom). In June of 2004, our BA-8180/U Zinc-Air battery was recognized by the U.S Army Research, Development and Engineering Command as one of the top ten inventions of 2003.

Our Zinc-Air batteries, rechargeable batteries and battery chargers for the military are manufactured through EFB. EFB's facilities have been granted ISO 9001 "Top Quality Standard" certification.

MARKETS/APPLICATIONS

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

CUSTOMERS

The principal customers for our Zinc-Air batteries during 2010 were the U.S. Army's Communications-Electronics Command (CECOM) and the Defense Logistics Agency (DLA). In addition, we continue to further penetrate Special Forces and other specific U.S. military units with direct sales.

COMPETITION

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

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

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

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

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

MANUFACTURING

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

Lifejacket Lights

PRODUCTS

We have a product line consisting of seven lifejacket light models, five for use with marine life jackets and two for use with aviation life vests, all of which work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations. We manufacture, assemble and package all our lifejacket lights through EFL in our factory in Beit Shemesh, Israel.

MARKETING

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

COMPETITION

The largest manufacturer of aviation and marine safety products, including TSO and SOLAS-approved lifejacket lights, is ACR Electronics Inc. of Hollywood, Florida. Other significant competitors in the marine market include Daniamant Aps of Denmark and England, and SIC of Italy.

Armor Division

We armor vehicles and manufacture aviation and other armor through our Armor Division. During 2010 and 2009, revenues from our Armor Division were approximately $19.5 million and $17.5 million, respectively.

Introduction

We specialize in manufacturing military armored combat vehicles based on commercial platforms. We also up-armor commercial vehicles for civilian use, and manufacture armor kits for aircraft and vessels by using state-of-the-art lightweight ballistic materials, special ballistic glass and advanced engineering processes.

We provide armored military vehicles and up-armored civilian SUVs, buses and vans. Through MDT Armor, we also provide ballistic armor kits for rotary and fixed wing aircraft under the trade name Armour of America.

We are a leading supplier to the Israeli military, Israeli Special Forces and special services. We provide products to the U.S. Army, and to military and defense and paramilitary customers worldwide. We are also actively exploring marketing armor products in India, through our 26% holding in Concord Safety Solutions Pvt. Ltd., an Indian company that we established together with an Indian vehicle manufacturing company and an Indian armor materials company.

Our products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide. We have acquired many years of battlefield experience in Israel. Our vehicles have provided proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings.

During 2010, we received over $7.3 million in orders from the Israel Defense Forces for the U.S.-built David, a patrol, combat command and reconnaissance armored vehicle that is specifically designed as an urban combat vehicle. We also introduced the Tiger; a new cost-effective, highly-armored light protected all-terrain vehicle.

In 2010, we entered into a teaming agreement with Textron Marine and Land Systems (TMLS), a division of Textron Systems. TMLS is a $2.3 billion supplier of military vessels and vehicles, part of the $15 billion Textron Corporation. The teaming agreement with Textron calls for joint production and marketing of MDT vehicles, which will be branded as Textron vehicles.

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

Sales, Marketing and Customers

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

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

Our aviation aircraft armor customers include L-3 Communications, the Boeing Company, the Army, NAVAIR, the Department of State, the Virginia police, and the police and/or military in Australia, Canada, Japan, Columbia, Brazil, and Chile.

Manufacturing

Our manufacturing facilities are located in Lod, Israel, and in Auburn, Alabama. In Israel we manufacture armored vehicles only, and in the U.S. we manufacture armored vehicles and aviation armor kits.

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

Competition

In the past two years MDT has shifted its focus from armored commercial vehicles to military vehicles such as the David and recently developed Tiger.

The global armored military vehicle industry is dominated by major industrial conglomerates, such as Israel's Plasan Sasa, BAE Systems, General Dynamics, Oshkosh, AM General, and International Truck in the US, Mercedes Benz in Germany, Iveco in Italy and Renault Trucks and Panard in France. In police armored vehicles, our competitors include Jankel Armouring Limited and Lenco Industries Inc.

All have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

In this connection, in 2010 we entered into a teaming agreement with Textron Marine and Land Systems (TMLS), a division of Textron Systems. TMLS is a $2.3 billion supplier of military vessels and vehicles, part of the $15 billion Textron Corporation. The teaming agreement with Textron calls for joint production and marketing of MDT vehicles, which will be branded as Textron vehicles. We believe that this teaming agreement will enable us to compete in the military vehicle market, overcoming the limitations of size.

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, 2010 and 2009, our backlog for the following year was approximately $44.0 million and $55.5 million, respectively, divided among our divisions as follows:

Division	2010	2009
Training and Simulation Division	$ 19,276,000	$ 31,245,000
Battery and Power Systems Division	15,702,000	13,802,000
Armor Division	9,039,000	10,468,000
TOTAL:	$ 44,017,000	$ 55,515,000

Major Customers

During 2010 and 2009, including all of our divisions, various branches of the United States military accounted for approximately 42% and 50% of our revenues.

Price Range of Common Stock

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

Year Ended December 31, 2010	High	Low
Fourth Quarter	$ 2.10	$ 1.45
Third Quarter	$ 1.95	$ 1.39
Second Quarter	$ 1.88	$ 1.40
First Quarter	$ 2.01	$ 1.35

Year Ended December 31, 2009	High	Low
Fourth Quarter	$ 2.35	$ 1.30
Third Quarter	$ 2.00	$ 1.25
Second Quarter	$ 2.17	$ 0.67
First Quarter	$ 0.83	$ 0.37

As of February 28, 2011 we had approximately 207 holders of record of our common stock.

Share Repurchase Program

In February of 2009, we authorized the repurchase in the open market or in privately negotiated transactions of up to $1.0 million of our common stock. Pursuant to this plan, through December 31, 2010 we have repurchased 563,209 shares of our common stock for $757,148 ($745,289 net of commissions), all of which was purchased after April 1, 2009. The following table shows information relating to the repurchase of our common stock during the three months ended December 31, 2010:

Period	Total Number of Shares Purchased	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans
October 1, 2010 through October 31, 2010	14,964	$ 1.87	14,964	$ 294,703
November 1, 2010 through November 30, 2010	22,848	$ 1.77	22,848	$ 254,711
December 1, 2010 through December 31, 2010	–	$ –	–	$ 254,711
TOTAL THIS QUARTER	37,812	$ 1.81	37,812	

(1) Average price paid per share includes commissions and is rounded to the nearest two decimal places.

The repurchase program is subject to management's discretion.

Dividends

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

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve inherent risks and uncertainties. When used in this discussion, the words "believes," "anticipated," "expects," "estimates" and similar expressions are intended to identify such forward-looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors including, but not limited to, those set forth elsewhere in this report. Please see the "Risk Factors" section in our filings with the Securities and Exchange Commission.

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

General

We are a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. We operate in three business units:

- we develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel (our ***Training and Simulation Division***);
- we manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications (our ***Battery and Power Systems Division***); and
- we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles and to manufacture personal and aviation armor (our ***Armoring Division***).

Critical Accounting Policies

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

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

Revenue Recognition

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

A portion of our revenue is derived from license agreements that entail the customization of FAAC's simulators to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with FASB ASC 605-35 based on the percentage of completion method over the period from signing of the license through to customer acceptance, as such simulators require significant modification or customization that takes time to complete. The percentage of completion is measured by monitoring progress using records of actual time incurred to date in the project compared with the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

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

We account for our other revenues from IES simulators in accordance with the provisions of FASB ASC 985-605. We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

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

Stock Based Compensation

We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of FASB ASC 505-50. Under FASB ASC 505-50, stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value of options using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

Allowance for Doubtful Accounts

We make judgments as to our ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding receivables. In determining the provision, we analyze our historical collection experience and current economic trends. We reassess these allowances each accounting period. Historically, our actual losses and credits have been consistent with these provisions. If actual payment experience with our customers is different than our estimates, adjustments to these allowances may be necessary resulting in additional charges to our statement of operations.

Accounting for Income Taxes

Significant judgment is required in determining our worldwide income tax expense provision. In the ordinary course of a global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities, the process of identifying items of revenue and expense that qualify for preferential tax treatment and segregation of foreign and domestic income and expense to avoid double taxation. Although we believe that our estimates are reasonable, the final tax outcome of these matters may be different than that which is reflected in our historical income tax provisions and accruals. Such differences could have a material effect on our income tax provision and net income (loss) in the period in which such determination is made.

We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under FASB ASC 740-10, involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses in the U.S. will not be realized in the foreseeable future. We do not provide for U.S. federal income taxes on the undistributed earnings of our foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

We have indefinitely-lived intangible assets consisting of trademarks, workforce, and goodwill. Pursuant to FASB ASC 350-10, these indefinitely-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these indefinitely-lived intangible assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a "naked tax credit." This deferred tax liability could remain on our balance sheet indefinitely unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

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

On January 1, 2007, we adopted the provisions of the FASB ASC 740-10. FASB ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. We must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. Uncertain tax positions require determinations and estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If our determinations and estimates prove to be inaccurate, the resulting adjustments could be material to its future financial results.

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

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2010, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

As of December 31, 2010, we had recorded goodwill of $32.8 million. We allocate goodwill acquired in a business combination to the appropriate reporting unit as of the acquisition date. Currently our reporting units are also our reportable segments and the associated goodwill was determined when the specific businesses in the reportable segments were purchased.

Under FASB ASC 350-10, goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests, and tests between annual tests in certain circumstances, based on estimated fair value in accordance with FASB ASC 350-10, and written down when impaired.

We determine fair value using a discounted cash flow analysis. This type of analysis requires us to make assumptions and estimates regarding industry economic factors and the profitability of future business strategies. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units. It is our policy to conduct impairment testing based on our current business strategy in light of present industry and economic conditions, as well as future expectations. In assessing the recoverability of our goodwill, we may be required to make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. This process is subjective and requires judgment at many points throughout the analysis. If our estimates or their related assumptions change in subsequent periods or if actual cash flows are below our estimates, we may be required to record impairment charges for these assets not previously recorded.

We completed our annual goodwill impairment review using the financial results as of the quarter ended June 30, 2010. We use a June 30 date because this allows us to use internal resources that are available before we start our annual audit process (we wait until our June 30 financials were reviewed by our external auditors before we start the actual goodwill impairment analysis). Additionally, since we engage outside services to complete three separate studies in our three different reporting units, using a June 30 date gives us ample time to engage the outside consultants, develop the analysis, review and approve the analysis, and have the study reviewed by both the U.S. and Israel-based external auditors.

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

- The long term horizon of the valuation process versus a short term valuation using current market conditions;
- The valuation by individual business segments versus the market share value based on our company as a whole;
- The valuations for each of the operating segments exceeded the carrying value by a minimum of 32%; and
- The fact that our stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in our securities was not acting as an informationally efficient reflection of all known information regarding us.

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

Other Intangible Assets

Other intangible assets are amortized to the Statement of Operations over the period during which benefits are expected to accrue, currently estimated at two to ten years.

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

Contingencies

We are from time to time involved in legal proceedings and other claims. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. We have not made any material changes in the accounting methodology used to establish our self-insured liabilities during the past three fiscal years.

A determination of the amount of reserves required, if any, for any contingencies are made after careful analysis of each individual issue. The required reserves may change due to future developments in each matter or changes in approach, such as a change in the settlement strategy in dealing with any contingencies, which may result in higher net loss.

If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

Warranty Reserves

Upon shipment of products to our customers, we provide for the estimated cost to repair or replace products that may be returned under warranty. Our warranty period is typically twelve months from the date of shipment to the end user customer. For existing products, the reserve is estimated based on actual historical experience. For new products, the warranty reserve is based on historical experience of similar products until such time as sufficient historical data has been collected on the new product. Factors that may impact our warranty costs in the future include our reliance on our contract manufacturer to provide quality products and the fact that our products are complex and may contain undetected defects, errors or failures in either the hardware or the software.

Functional Currency

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

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

Executive Summary

Overview of Results of Operations

We incurred operating losses for the years ended December 31, 2010 and 2009. While we expect to continue to derive revenues from the sale of products that we manufacture and the services that we provide, there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis.

A portion of our operating loss during 2010 and 2009 arose as a result of non-cash charges. These charges were primarily related to our acquisitions, financings and stock-based awards to employees. To the extent that we continue certain of these activities during 2011, we would expect to continue to incur such non-cash charges in the future.

ACQUISITIONS

In acquisition of subsidiaries, part of the purchase price is allocated to intangible assets and goodwill. Amortization of intangible assets related to acquisition of subsidiaries is recorded based on the estimated expected life of the assets. Accordingly, for a period of time following an acquisition, we incur a non-cash charge related to amortization of intangible assets in the amount of a fraction (based on the useful life of the intangible assets) of the amount recorded as intangible assets. Such amortization charges continued during 2010. We are required to review intangible assets for impairment whenever events or changes in circumstances indicate that carrying amount of the assets may not be recoverable. If we determine, through the impairment review process, that intangible asset has been impaired, we must record the impairment charge in our statement of operations.

In the case of goodwill, the assets recorded as goodwill are not amortized; instead, we are required to perform an annual impairment review. If we determine, through the impairment review process, that goodwill has been impaired, we must record the impairment charge in our statement of operations.

As a result of the application of the above accounting rule, we incurred non-cash charges for amortization of intangible assets in 2010 and 2009 in the amount of $1.7 million and $1.5 million, respectively.

FINANCINGS AND ISSUANCES OF RESTRICTED SHARES, OPTIONS AND WARRANTS

The non-cash charges that relate to our financings occurred in connection with our issuance of convertible debt securities with detachable warrants, and in connection with our repricing of certain warrants and grants of new warrants. When we issue convertible securities, we record a discount (representing the value of the detachable warrants and the derivative features of the debt) that is amortized ratably over the life of the debenture. When a debenture is converted, however, the entire remaining unamortized discount is immediately recognized as expense in the quarter in which the debenture is converted. During 2010 and 2009, we recorded credits of approximately $167,000 and expense of $270,000, respectively, attributable to amortization related to warrants issued to the holders of convertible notes.

During 2010 and 2009, we issued restricted shares and restricted stock units to certain of our employees and to our directors. Each restricted stock unit is equal to one share of Company stock and is only redeemable for stock. These shares were issued as stock bonuses or were the required annual grant to directors, and are restricted for a period of up to three years from the date of issuance. Relevant accounting rules provide that the aggregate amount of the difference between the purchase price of the restricted shares or restricted stock units (in this case, generally zero) and the market price of the shares on the date of grant is taken as a general and administrative expense, amortized over the life of the period of the restriction.

As a result of the application of the above accounting rules, we incurred non-cash charges related to stock-based compensation in 2010 and 2009 in the amount of $742,000 and $849,000, respectively.

During the third quarter of 2008 and pursuant to the terms of a Securities Purchase Agreement dated August 14, 2008, we issued and sold to a group of institutional investors 10% senior convertible notes in the aggregate principal amount of $5.0 million due August 15, 2011. These notes are convertible at any time prior to August 15, 2011 at a conversion price of $2.24 per share.

As part of the securities purchase agreement, we issued to the purchasers of our 10% senior convertible notes due August 15, 2011, warrants to purchase an aggregate of 558,036 shares of common stock at any time prior to August 15, 2011 at a price of $2.24 per share. The warrants were classified in 2008 as equity based on relative fair value. The relative fair value of these warrants was determined in 2008 using the Black-Scholes pricing model, assuming a risk-free interest rate of 2.78%, a volatility factor 75%, dividend yields of 0% and a contractual life of 3.0 years.

As part of our analysis of the convertible debt and related warrants, we reviewed and followed the guidance of FASB ASC 718-10, ASC 815-40-15, ASC 470-20-30 and ASC 105-10-05. In connection with the original accounting for these convertible notes, we recorded a debt discount on the balance sheet of $412,000 in 2008. The beneficial conversion feature and the discount arising from fair value allocation of the warrants according to FASB ASC 470-20-25 is being amortized from the date of issuance to the stated redemption date – August 15, 2011.

On January 1, 2009, we adopted FASB ASC 815-40-15, "Determining Whether an Instrument is Indexed to an Entity's Own Stock." FASB ASC 815-40-15 requires us to re-evaluate the warrants issued with the convertible notes and to also re-evaluate the embedded conversion option and embedded put options within the Notes to determine if the previous accounting for these items would change. Upon this re-evaluation, we were required to reclassify the warrants along with the value of the embedded conversion feature from equity to a derivative liability. The embedded put options remained classified as derivative liabilities. We again used the Black-Scholes valuation model and other factors to determine the value of the warrants, the value of the embedded conversion feature and the value of the embedded put options associated with the convertible notes as of January 1, 2009. In accordance with the guidance of FASB ASC 815-40-15, a cumulative adjustment increasing January 1, 2009 retained earnings by $471,000 was made in the first quarter of 2009 to reflect this new accounting.

On December 31, 2010 and 2009, we revalued these warrants, the embedded conversion option and the embedded put options. The credit to financial expense associated with this revaluation is approximately $233,000 for 2010 and a financial expense of $342,000 in 2009.

Concurrent with a Securities Purchase Agreement dated August 14, 2008, we purchased a $2.5 million Senior Subordinated Convertible Note from an unaffiliated company, DEI Services Corporation ("DEI"). This 10% Senior Subordinated Convertible Note (the "DEI Note") was due December 31, 2009. The DEI Note was convertible at maturity at our option into such number of shares of DEI's common stock, no par value per share, as shall be equal at the time of conversion to twelve percent (12%) of DEI's outstanding common stock. In the third quarter of 2009, we wrote down the value of the DEI Note by $500,000, to $2.0 million.

On August 10, 2010, DEI repaid the entire $2.5 million principal amount of the DEI Note, along with all outstanding earned and unpaid interest of $151,000. Inasmuch as we had previously established an allowance of $500,000 in the fourth quarter 2009 on the DEI Note based on our expectation that we would not collect the entire DEI Note, we recognized the difference between the $2.0 million book value of the DEI Note and the $2.5 million that was actually collected as a recovery under allowance for settlements on our financial statements. Additionally, we accrued unpaid interest on the DEI Note through June 30, 2010 in the amount of $140,000, which was recorded as a reduction of financial expenses and additionally recorded $11,000 in interest income in the third quarter of 2010. This transaction extinguished our conversion options and rights of first refusal with respect to DEI.

Overview of Operating Performance and Backlog

Overall, our pre-tax loss for 2010 was $1.0 million on revenues of $73.7 million, compared to a pre-tax loss of $2.2 million on revenues of $74.5 million during 2009. As of December 31, 2010, our overall backlog totaled $44.0 million.

In our Training and Simulation Division, revenues decreased from approximately $39.2 million in 2009 to $35.6 million in 2010. As of December 31, 2010, our backlog for our Training and Simulation Division totaled $19.3 million.

In our Battery and Power Systems Division, revenues increased from approximately $17.8 million in 2009 to approximately $18.7 million in 2010. As of December 31, 2010, our backlog for our Battery and Power Systems Division totaled $15.7 million.

In our Armor Division, revenues increased from approximately $17.5 million in 2009 to approximately $19.5 million in 2010. As of December 31, 2010, our backlog for our Armor Division totaled $9.0 million.

Common Stock Repurchase Program

In February 2009, we authorized the repurchase in the open market or in privately negotiated transactions of up to $1.0 million of our common stock. Pursuant to this plan, through December 31, 2010 we have repurchased 563,209 shares of our common stock for $757,148 ($745,289 net of commissions), all of which was purchased after April 1, 2009. At December 31, 2010, we had remaining authorization for the repurchase of up to $254,711 in shares of our common stock. The repurchase program is subject to the discretion of our management.

Results of Operations

Preliminary Note

SUMMARY

Following is a table summarizing our results of operations for the years ended December 31, 2010 and 2009, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2010	2009
Revenues:		
Training and Simulation Division	$ 35,562,297	$ 39,206,173
Battery and Power Systems Division	18,675,517	17,820,980
Armor Division	19,503,664	17,507,298
	$ 73,741,478	$ 74,534,451
Cost of revenues:		
Training and Simulation Division	$ 21,363,731	$ 24,568,708
Battery and Power Systems Division	15,948,545	15,328,722
Armor Division	15,791,550	14,517,491
	$ 53,103,826	$ 54,414,921
Research and development expenses:		
Training and Simulation Division	$ 887,809	$ 569,984
Battery and Power Systems Division	540,970	249,933
Armor Division	1,100,188	506,838
	$ 2,528,967	$ 1,326,755

	Year Ended December 31, 2010	
	2010	**2009**
Sales and marketing expenses:		
Training and Simulation Division	$ 4,128,796	$ 3,387,993
Battery and Power Systems Division	746,505	697,568
Armor Division	981,440	782,937
Corporate	40,627	–
	$ 5,897,368	$ 4,868,498
General and administrative expenses:		
Training and Simulation Division	$ 3,566,856	$ 4,651,130
Battery and Power Systems Division	906,183	1,079,063
Armor Division	1,665,157	1,588,973
Corporate	5,123,018	4,979,429
	$ 11,261,214	$ 12,298,595
Amortization of intangible assets:		
Training and Simulation Division	$ 1,201,281	$ 936,212
Battery and Power Systems Division	509,240	509,240
Armor Division	13,350	13,350
	$ 1,723,871	$ 1,458,802
Operating profit (loss):		
Training and Simulation Division	$ 4,413,824	$ 5,092,146
Battery and Power Systems Division	24,074	(43,546)
Armor Division	(48,021)	97,709
Corporate	(5,163,645)	(4,979,429)
	$ (773,768)	$ 166,880
Other income:		
Training and Simulation Division	$ 46,208	$ 31,591
Battery and Power Systems Division	48	293
Armor Division	102,128	53,778
	$ 148,384	$ 85,662
Allowance for settlements:		
Corporate	$ 303,068	$ 1,250,000
	$ 303,068	$ 1,250,000
Financial income (expense):		
Training and Simulation Division	$ 7,264	$ 1,342
Battery and Power Systems Division	(93,670)	70,819
Armor Division	246,471	214,042
Corporate	(52,798)	965,182
	$ 107,267	$ 1,251,385
Tax expenses (credits):		
Training and Simulation Division	$ 48,467	$ 183,621
Battery and Power Systems Division	(556,258)	28,926
Armor Division	(709)	(25,674)
Corporate	390,000	618,093
	$ (118,500)	$ 804,966
Net income (loss):		
Training and Simulation Division	$ 4,404,301	$ 4,938,774
Battery and Power Systems Division	674,050	(142,998)
Armor Division	(191,655)	(36,881)
Corporate	(5,803,915)	(7,812,704)
	$ (917,219)	$ (3,053,809)

Fiscal Year 2010 compared to Fiscal Year 2009

Revenues. During 2010, we (through our subsidiaries) recognized revenues as follows:

- FAAC, IES and RTI recognized revenues from the sale of military operations and vehicle simulators, interactive use-of-force training systems and from the provision of maintenance services in connection with such systems.
- EFB and Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military and commercial customers, and under certain development contracts with the U.S. Army.
- EFL recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products.

Revenues for 2010 totaled $73.7 million, compared to $74.5 million in 2009, a decrease of $793,000, or 1.1%. This decrease was primarily attributable to the following factors:

- Decreased revenues from our Training and Simulation Division ($3.6 million less in 2010 versus 2009), due primarily to a simulation contract with the military that concluded in 2009.
- Increased revenues from our Battery and Power Systems Division ($855,000 more in 2010 versus 2009), due primarily to increased orders for our battery products at EFB and EFL, offset by a decrease in revenue at Epsilor.
- Increased revenues from our Armor Division ($2.0 million more in 2010 versus 2009), due primarily to increased production of the David vehicle.

The table below details the percentage of total recognized revenue by type of arrangement for the years ended December 31, 2010 and 2009:

	Year Ended December 31,	
Type of Revenue	**2010**	**2009**
Sale of products	93.7%	95.6%
Maintenance and support agreements..............................	4.2%	2.5%
Long term research and development contracts	2.1%	1.9%
Total...	100.0%	100.0%

Cost of revenues. Cost of revenues totaled $53.1 million during 2010, compared to $54.4 million in 2009, a decrease of $1.3 million, or 2.4%, due primarily to decreased revenues in our Training and Simulation Division offset to a lesser extent by increased revenues in our Battery and Power Systems and Armor Divisions. Cost of revenues as a percentage of revenue also decreased in each division due to several factors, including favorable variances in raw materials along with increased operating efficiencies.

Cost of revenues for our three divisions during 2010 were $21.4 million for the Training and Simulation Division (compared to $24.6 million in 2009, a decrease of $3.2 million, or 13.0%, due primarily to the reduction in revenues for the period); $15.9 million for the Battery and Power Systems Division (compared to $15.3 million in 2009, an increase of $620,000, or 4.0%, due primarily to increased orders for our battery and charger products); and $15.8 million for the Armor Division (compared to $14.5 million in 2009, an increase of $1.3 million, or 8.8%, due primarily to increased production of the David vehicle and by improved operating efficiencies).

Research and development expenses. Research and development expenses for 2010 were $2.5 million, compared to $1.3 million during 2009, an increase of $1.2 million, or 90.6%, due primarily to the development of new vehicles in the Armor Division along with increases in new product development in the other divisions. In particular, the Armor Division has invested a significant amount of resources to develop our new Tiger vehicle, which has been displayed in trade shows both overseas and in the United States.

Selling and marketing expenses. Selling and marketing expenses for 2010 were $5.9 million, compared to $4.9 million in 2009, an increase of $1.0 million, or 21.1%, due primarily to increased expenses in the Training and Simulation Division related to an increase in the sales force and increased participation in trade shows along with increased expenses in the Armor Division related to marketing the newly-developed Tiger vehicle.

General and administrative expenses. General and administrative expenses for 2010 were $11.3 million, compared to $12.3 million in 2009, a decrease of $1.0 million, or 8.4%. This decrease was primarily attributable to a recovery of legal expenses in 2010 and the write-off of a note receivable in 2009 in our Training and Simulation Division.

Amortization of intangible assets. Amortization of intangible assets totaled $1.7 million in 2010, compared to $1.5 million in 2009, an increase of $265,000, or 18.2%, due primarily to the increase in amortization of capitalized software in our Training and Simulation Division.

Allowance for settlements. In the fourth quarter of 2009, we recorded an allowance in the amount of $750,000 relating to a potential adverse judgment in the litigation between our AoA subsidiary (which has since been merged into MDT) and NAVAIR. In the fourth quarter of 2010, we recorded an additional allowance of $803,000 related to the NAVAIR litigation. See "Item 3. Legal Proceedings – NAVAIR Litigation." In the second quarter of 2010, we recorded a positive adjustment in the amount of $500,000 to reflect the fact that the DEI Note was paid in full in the third quarter of 2010 and the consequent reversal of an allowance recorded in the third quarter of 2009 relating to the DEI Note.

Financial expenses, net. Financial expenses totaled approximately $107,000 in 2010 compared to $1.3 million in 2009, a decrease of $1.1 million, or

91.4%. The difference was primarily due to a decrease in warrant liability and debt discount expense from 2009.

Income taxes. We recorded a total of $118,500 in tax benefits in 2010, compared to $805,000 in tax expenses in 2009. We and certain of our subsidiaries incurred net operating losses during 2010 but were subject to a federal alternative minimum tax in the amount of $62,000. Due to the merger of Epsilor and EFL, we recorded a reduced valuation allowance of $613,000 in the fourth quarter for future tax credits over the following three years. With respect to some of our subsidiaries that operated at a net profit during 2010, we were able to offset federal taxes against our accumulated loss carry forward but recorded $74,000 in state and local taxes. We recorded the required adjustment of taxes due to the deduction of goodwill amortization for U.S. federal taxes, which totaled $325,000 in 2010 and $560,000 in 2009.

Net loss. Due to the factors cited above, net loss decreased to $917,000 in 2010 from $3.1 million in 2009, a difference of $2.1 million, or 70.0%.

Liquidity and Capital Resources

As of December 31, 2010, we had $6.3 million in cash and $1.8 million in restricted collateral deposits, as compared to at December 31, 2009, when we had $1.9 million in cash and $2.0 million in restricted collateral deposits. We also had $6.7 million in unused bank lines of credit with our main bank as of December 31, 2010, under a $10.0 million credit facility under our FAAC subsidiary, which is secured by our assets and the assets of our other subsidiaries and guaranteed by us. There was $3.3 million of available credit on this line as of December 31, 2010 based on our borrowing base calculations. Our primary credit facility includes covenants restricting our Total Senior Liabilities to Tangible Net Worth and Funded Debt to EBITDA along with a limitation on cash distributions to our affiliated companies. As of December 31, 2010, we were in compliance with all covenants.

We used available funds in 2010 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We purchased approximately $1.3 million of property and equipment during 2010. Our net property and equipment amounted to $4.6 million as of December 31, 2010.

Net cash provided by operating activities from continuing operations for 2010 and 2009 was $9.1 million and $2.0 million, respectively, an improvement of $7.1 million. We experienced a significant increase in operating cash flow in 2010 compared to 2009, primarily the result of a $2.0 million reduction in the net loss, a $2.7 million improvement in inventory due to the completion of certain projects, a $2.0 million improvement in other accounts receivable and a $1.5 million improvement in deferred revenues.

Net cash used in investing activities for 2010 and 2009 was $2.0 million and $3.1 million, respectively, a decrease of $1.1 million. This decrease was primarily the result of smaller increases in restricted collateral deposits offset by purchases of property and equipment.

Net cash used in financing activities for 2010 and 2009 was $2.8 million and $1.4 million, respectively, an increase of $1.5 million, primarily due to a decrease in short term borrowing.

As of December 31, 2010, we had approximately $2.5 million in short term bank debt and $2.4 million in long-term debt outstanding, including current maturities.

Subject to all of the reservations regarding “forward-looking statements” set forth above, we believe that our present cash position, anticipated cash flows from operations and availability under our lines of credit should be sufficient to satisfy our current estimated cash requirements through the remainder of the year. In this connection, we note that from time to time our working capital needs are partially dependent on our subsidiaries’ lines of credit.

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

Effective Corporate Tax Rate

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2010 and 2009. With respect to some of our U.S. subsidiaries that operated at a net profit during 2010, we were able to offset federal taxes against our net operating loss carryforward. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. With respect to certain of our Israeli subsidiaries that operated at a net profit during 2010, we were unable to offset their taxes against our net operating loss carryforward, and we are therefore exposed to Israeli taxes, at a rate of up to 26% in 2010 (less, in the case of companies that have “approved enterprise” status as discussed in Note 14.b. to the Notes to Financial Statements). We also set up a tax liability for the impact of the deductions taken for goodwill.

As of December 31, 2010, we had a U.S. net operating loss carryforward of approximately $27.8 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2011 through 2026, and foreign net operating and capital loss carryforwards of approximately $89.9 million, which are available indefinitely to offset future taxable income under certain circumstances.

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2010, our management, including the principal executive officer and principal financial officer, evaluated our disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in our periodic reports that we file with the SEC. These disclosure controls and procedures are intended to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers, by other of our employees, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Any system of controls and procedures, no matter how well designed and operated, can at best provide only reasonable assurance that the objectives of the system are met and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met.

Based on their evaluation as of December 31, 2010, our principal executive officer and principal financial officer were able to conclude that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective.

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

Management's Report on Internal Control Over Financial Reporting

Our management, including our principal executive and financial officers, is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Our management has evaluated the effectiveness of our internal controls as of the end of the period covered by this Annual Report on Form 10-K for the year ended December 31, 2010. In making our assessment of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in *Internal Control – Integrated Framework*.

Based on management's assessment and these criteria, our management concluded that our internal control over financial reporting was effective as of December 31, 2010.

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

Changes in Internal Controls Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter to which this Annual Report on Form 10-K relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Arotech Corporation,
Ann Arbor, Michigan:

We have audited the accompanying consolidated balance sheets of Arotech Corporation (the "Company") as of December 31, 2010 and 2009 and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the years then ended. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arotech Corporation and subsidiaries at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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

/s/ BDO USA, LLP

Grand Rapids, Michigan
March 30, 2011

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31, 2010	December 31, 2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 6,335,307	$ 1,901,525
Available for sale securities	399,449	–
Restricted collateral deposits	1,842,143	1,997,165
Trade receivables (net of allowance for doubtful accounts in the amount of $47,000 as of December 31, 2010 and 2009)	13,812,906	14,010,974
Unbilled receivables	3,280,821	4,142,107
Other accounts receivable and prepaid expenses	852,935	2,825,202
Inventories	9,654,009	12,335,037
Total current assets	36,177,570	37,212,010
LONG TERM ASSETS:		
Deferred tax assets	652,292	41,405
Severance pay fund	4,126,835	3,447,884
Other long term receivables	374,499	395,456
Property and equipment, net	4,639,511	4,624,833
Investment in affiliated company	7,018	67,018
Other intangible assets, net	4,878,754	6,025,600
Goodwill	32,780,460	32,303,673
Total long term assets	47,459,369	46,905,869
Total assets	$ 83,636,939	$ 84,117,879

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, 2010	December 31, 2009
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 4,382,160	$ 5,149,243
Other accounts payable and accrued expenses	6,527,347	6,239,436
Current portion of capitalized leases	39,181	45,911
Current portion of long term debt	1,417,543	1,902,097
Short term bank credit	2,488,206	4,074,890
Deferred revenues	5,926,460	4,434,093
Total current liabilities	20,780,897	21,845,670
LONG TERM LIABILITIES		
Accrued severance pay	5,843,305	4,985,011
Long term portion of capitalized leases	11,549	52,021
Long term debt	1,023,008	2,270,152
Deferred tax liability	3,315,000	2,990,000
Other long term liabilities	178,811	555,220
Total long-term liabilities	10,371,673	10,852,404
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – $0.01 par value each;		
Authorized: 50,000,000 shares as of December 31, 2010 and 2009; Issued and outstanding: 14,842,283 shares and 14,405,948 shares as of December 31, 2010 and 2009, respectively	148,423	144,060
Preferred shares – $0.01 par value each		
Authorized: 1,000,000 shares as of December 31, 2010 and 2009; No shares issued and outstanding as of December 31, 2010 and 2009	–	–
Additional paid-in capital	221,856,095	220,481,911
Accumulated deficit	(170,705,241)	(169,788,022)
Notes receivable from stockholders	(954,647)	(954,647)
Accumulated other comprehensive income	2,139,739	1,536,503
Total stockholders' equity	52,484,369	51,419,805
Total liabilities and stockholders' equity	$ 83,636,939	$ 84,117,879

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

In U.S. dollars

	December 31,	
	2010	**2009**
Revenues	$73,741,478	$74,534,451
Cost of revenues, exclusive of amortization of intangibles	53,103,826	54,414,921
Research and development expenses	2,528,967	1,326,755
Selling and marketing expenses	5,897,368	4,868,498
General and administrative expenses	11,261,214	12,298,595
Amortization of intangible assets and capitalized software	1,723,871	1,458,802
Total operating costs and expenses	74,515,246	74,367,571
Operating profit (loss)	(773,768)	166,880
Other income	148,384	85,662
Allowance for settlements, net	(303,068)	(1,250,000)
Financial expense, net	(107,267)	(1,251,385)
Total other expense	(261,951)	(2,415,723)
Loss before income tax expenses	(1,035,719)	(2,248,843)
Income tax expense (benefit)	(118,500)	804,966
Net loss	$ (917,219)	$ (3,053,809)
Basic and diluted net loss per share	$ (0.07)	$ (0.24)
Weighted average number of shares used in computing basic and diluted net loss per share	13,304,039	12,777,867

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

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

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
	Shares	Amount						
Balance as of December 31, 2008	13,637,639	$ 136,377	$ 220,124,075	$ (167,205,514)	$(1,357,788)	$1,526,199	$ –	$ 53,223,349
ASC 815-40 cumulative adjustment	–	–	(412,300)	471,301	–	–	–	59,001
Balance as of January 1, 2009	13,637,639	136,377	219,711,775	(166,734,213	(1,357,788)	1,526,199	–	53,282,350
Treasury stock purchase	(447,358)	(4,474)	(559,082)	–	–	–	–	(563,556)
Conversion of convertible notes	220,017	2,200	453,044	–	–	–	–	455,244
Stock based compensation	–	–	849,272	–	–	–	–	849,272
Restricted stock issued	412,622	4,126	(4,126)	–	–	–	–	–
Forfeitures of prior stock awards	(19,712)	(197)	197	–	–	–	–	–
Issuance of stock in lieu of funding severance	602,740	6,028	433,972	–	–	–	–	440,000
Write-down of shareholder loans	–	–	(403,141)	–	403,141	–	–	–
Other comprehensive income – foreign currency translation adjustment	–	–	–	–	–	10,304	10,304	10,304
Net loss	–	–	–	(3,053,809)	–	–	(3,053,809)	(3,053,809)
Total comprehensive loss							$ (3,043,505)	
Balance as of December 31, 2009	14,405,948	$ 144,060	$ 220,481,911	$ (169,788,022)	$ (954,647)	$1,536,503		$ 51,419,805

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

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

In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
	Shares	Amount						
Balance as of January 1, 2010	14,405,948	$ 144,060	$220,481,911	$ (169,788,022)	$ (954,647)	$1,536,503	$ –	$ 51,419,805
Treasury stock purchase	(115,851)	(1,158)	(192,434)	–	–	–	–	(193,592)
Conversion of convertible notes	440,277	4,402	826,178	–	–	–	–	830,580
Stock based compensation	–	–	741,559	–	–	–	–	741,559
Restricted stock issued	382,326	3,823	(3,823)	–	–	–	–	–
Restricted stock units vested	60,417	604	(604)	–	–	–	–	–
Forfeitures of prior stock awards	(330,834)	(3,308)	3,308	–	–	–	–	–
Other comprehensive income – Unrealized gain/(loss) on marketable securities	–	–	–	–	–	(3,256)	(3,256)	(3,256)
Foreign currency translation adjustment	–	–	–	–	–	606,492	606,492	606,492
Net loss	–	–	–	(917,219)	–	–	(917,219)	(917,219)
Total comprehensive loss							$ (313,983)	
Balance as of December 31, 2010	14,842,283	$ 148,423	$221,856,095	$ 170,705,241	$ (954,647)	$2,139,739		$ 52,484,369

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

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (917,219)	$ (3,053,809)
Adjustments required to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation	1,173,626	1,260,458
Amortization of intangible assets and capitalized software	1,723,871	1,458,802
Amortization of debt discount	162,793	269,801
Compensation related to shares issued to employees, consultants and directors	741,559	849,272
Adjustment to value of warrants and embedded features on the senior convertible notes	(232,758)	341,916
Capital gain (loss) from sale of property and equipment	47,722	(14,640)
Deferred taxes	(285,887)	590,709
Allowances for settlements, excluding recoveries on notes receivable	803,068	1,250,000
Changes in operating assets and liabilities:		
Severance pay, net	179,343	(295,454)
Trade receivables	198,068	5,335,110
Other accounts receivable and prepaid expenses	1,993,224	369,077
Inventories	2,681,028	(2,656,077)
Unbilled receivables	861,286	627,157
Deferred revenues	1,492,367	645,073
Trade payables	(767,083)	(4,515,315)
Other accounts payable and accrued expenses	(658,805)	(442,130)
Net cash provided by (used in) operating activities	9,196,203	2,019,950
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment, net of investment grants received from the State of Israel	(1,321,952)	(896,972)
Additions to capitalized software development	(548,210)	(680,398)
Changes in value of investment in affiliated company	60,000	(26,031)
Proceeds from sale of property and equipment	85,926	84,584
Sales of marketable securities	–	49,947
Investment in marketable securities	(402,705)	–
Decrease (increase) in restricted collateral deposits	155,022	(1,616,322)
Net cash provided by (used in) investing activities	(1,971,919)	(3,085,192)
FORWARD	$ 7,224,284	$ (1,065,242)

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

In U.S. dollars

	2010	2009
FORWARD	$ 7,224,284	$ (1,065,242)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of long term debt	(1,111,116)	(1,259,039)
Increase (decrease) in short term bank credit	(1,586,684)	467,000
Purchase of treasury stock	(193,592)	(563,556)
Net cash provided by (used in) financing activities	(2,891,392)	(1,355,595)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,332,892	(2,420,837)
CASH ACCRETION DUE TO EXCHANGE RATE DIFFERENCES	100,890	21,003
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	1,901,525	4,301,359
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	$ 6,335,307	$ 1,901,525
SUPPLEMENTARY INFORMATION ON NON-CASH AND OTHER TRANSACTIONS:		
Interest paid during the year	$ 531,101	$ 671,356
Taxes on income paid during the year	$ 189,926	$ 162,774
Note conversion to common stock	$ 830,580	$ 455,244
Write-off of non-recourse shareholder loans	$ –	$ 403,141
Issuance of stock in lieu of funding severance	$ –	$ 440,000

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

NOTE 1:– GENERAL

a. Corporate structure:

Arotech Corporation ("Arotech") and its wholly-owned subsidiaries (the "Company") provide defense and security products for the military, law enforcement and homeland security markets, including advanced zinc-air and lithium batteries and chargers, multimedia interactive simulators/trainers and lightweight vehicle armoring. The Company operates primarily through its wholly-owned subsidiaries FAAC Incorporated ("FAAC"), based in Ann Arbor, Michigan and Royal Oak, Michigan; MDT Protective Industries, Ltd. ("MDT"), based in Lod, Israel; MDT Armor Corporation ("MDT Armor"), based in Auburn, Alabama; Electric Fuel Battery Corporation ("EFB"), based in Auburn, Alabama; Electric Fuel Ltd. ("EFL"), based in Beit Shemesh, Israel; and Epsilor Electronic Industries, Ltd. ("Epsilor"), based in Dimona, Israel. The Company's former subsidiary Armour of America Incorporated ("AoA") has been merged into MDT Armor. Additionally, IES Interactive Training ("IES"), and Realtime Technologies ("RTI") were merged with FAAC to create Arotech's Training and Simulation Division ("ATSD").

b. Impairment of goodwill and other intangible assets:

Goodwill is tested for impairment at least annually and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reporting units with their carrying value. All of the Company's reporting units have goodwill subject to annual testing. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital. In both 2010 and 2009, the Company evaluated all goodwill at mid-year and determined that there was no impairment.

The Company completed its 2010 annual goodwill impairment review using the financial results as of the quarter ended June 30, 2010. Although the cumulative book value of the Company's reporting units exceeded the Company's market value as of the impairment review, management nevertheless determined that the fair value of the respective reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill. Several factors contributed to this determination:

- The long term horizon of the valuation process versus a short term valuation using current market conditions;
- The valuation by individual business segments versus the market share value based on the Company as a whole;
- The valuations for each of the operating segments exceeded the carrying value by a minimum of 32%; and
- The fact that the Company's stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in the Company's securities was not acting as an informationally efficient reflection of all known information regarding the Company.

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

The Company's long-lived assets and amortizable identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

c. Related parties

The Company has had a consulting agreement with Sampen Corporation since 2005. Sampen is a New York corporation owned by members of the immediate family of one of the Company's executive officers,

NOTE 1:– GENERAL (Cont.)

and this executive officer is an employee of both the Company and of Sampen. The term of this consulting agreement was extended automatically for additional term of two years until December 31, 2012, unless either Sampen or the Company terminates the agreement sooner.

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

During the years ended December 31, 2010 and 2009, the Company paid Sampen a total of $185,856 and $178,356, respectively.

On December 3, 1999, Robert S. Ehrlich purchased 8,928 shares of the Company's common stock out of the Company's treasury at the closing price of the Company's common stock on December 2, 1999. Payment was rendered by Mr. Ehrlich in the form of non-recourse promissory notes due in 2009 in the amount of $167,975, bearing simple annual interest at a rate of 2%, secured by the shares of common stock purchased and other shares of common stock previously held by him. As of December 31, 2008, the aggregate amount outstanding pursuant to these promissory notes from Mr. Ehrlich and a former employee with the same arrangement were $403,141, which were not repaid and were therefore written off to paid-in capital in the fourth quarter of 2009. Pursuant to the terms of the notes, the shares of stock securing the note were returned to the Company.

On February 9, 2000, Mr. Ehrlich exercised 9,404 stock options. Mr. Ehrlich paid the exercise price of the stock options and certain taxes that the Company paid on his behalf by giving the Company a non-recourse promissory note due in 2025 in the amount of $329,163, bearing annual interest at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, secured by the shares of the Company's common stock acquired through the exercise of the options and certain compensation due to Mr. Ehrlich upon termination. As of December 31, 2010, the aggregate amount outstanding pursuant to this promissory note was $452,995. Again, there is a former employee with the same arrangement.

On June 10, 2002, Mr. Ehrlich exercised 3,571 stock options. Mr. Ehrlich paid the exercise price of the stock options by giving the Company a non-recourse promissory note due in 2012 in the amount of $36,500, bearing simple annual interest at a rate equal to the lesser of (i) 5.75%, and (ii) 1% over the then-current federal funds rate announced from time to time, secured by the shares of the Company's common stock acquired through the exercise of the options. As of December 31, 2010, the aggregate amount outstanding pursuant to this promissory note was $46,593.

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

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

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

accounts maintained in currencies other than dollars are remeasured into dollars, with resulting gains and losses reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

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

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Restricted collateral deposits:

Restricted collateral deposits are primarily invested in highly liquid deposits which are used as a security for the Company's performance guarantees at FAAC, Epsilor and MDT Armor.

f. Marketable securities:

The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Investment in securities are classified as available-for-sale and stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of operations.

g. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence and for market prices lower than cost. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are made to write inventory down to its market value. In 2010 and 2009, the Company wrote off $47,000 and $12,000, respectively, of obsolete inventory, which has been included in the cost of revenues.

Cost is determined as follows:

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

Work in progress – represents the cost of manufacturing with additions of allocable indirect and direct manufacturing cost.

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

h. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants received from the State of Israel for investments in fixed assets under the Investment Law. Investment grants of approximately $270,000 were received in 2009 and none in 2010.

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

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

i. Revenue recognition:

The Company is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. During 2010 and 2009, the Company recognized revenues as follows: (i) from the sale and customization of interactive training systems and from the maintenance services in connection with such systems (Training and Simulation Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery and Power Systems Division); and (iv) from the sale of lifejacket lights (Battery and Power Systems Division).

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

Revenues from contracts in the Training and Simulation Division that involve customization of the system to customer specific specifications are recognized using contract accounting on a percentage of completion method, in accordance with the "Input Method." The amount of revenue recognized is based on the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual time, materials and other costs incurred to date in the project compared to the total estimated project requirement. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. Typically revenue is recognized, per the contract, either when shipped or delivered. Normally there are no further obligations that would preclude the recognition of revenue.

The Company believes that the use of the percentage of completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and the terms of settlement, including in cases of terminations for convenience. In all cases, the Company expects to perform its contractual obligations and its customers are expected to satisfy their obligations under the contract.

Revenues from simulators that do not require significant customization are recognized when persuasive evidence of an agreement exists, delivery has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectability is probable.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support services. Revenues from training are recognized when it is performed. The Vendor Specific Objective Evidence ("VSOE") of fair value of

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

the maintenance, training and support services is determined based on the price charged when sold separately or when renewed.

Unbilled receivables include cost and gross profit earned in excess of billing.

Deferred revenues include unearned amounts received under maintenance and support services and billing in excess of costs and estimated earnings on uncompleted contracts.

j. Warranty:

The Company typically offers a one to two year warranty for most of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the Company does business. The Company estimates the costs that may be incurred under its basic limited warranty, including parts and labor, and records deferred revenue in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its reserves and adjusts the amounts as necessary.

k. Research and development cost:

The Company capitalizes certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products are generally charged to expenses as incurred. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release have been capitalized. Capitalized software costs will be amortized by the greater of the amount computed using: (i) the ratio that current gross revenues from sales of the software bears to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (one to three years). The Company assesses the net realizable value of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2010.

In 2010 and 2009, the Training and Simulation Division capitalized approximately $548,000 and $680,000, respectively, in software development costs that will be amortized on a straight-line method over 2 years, the useful life of the software.

l. Income taxes:

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

m. Concentrations of credit risk:

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

The trade receivables of the Company are mainly derived from sales to customers located primarily in the United States and Israel along with the countries listed in footnote 16 c. Management believes that credit risks are moderated by the diversity of its end customers and geographical sales areas. The Company performs ongoing credit evaluations of its customers' financial condition. An allowance for doubtful ac-

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

counts is determined with respect to those accounts that the Company has determined to be doubtful of collection.

The Company's available-for-sale marketable securities have included investments in debentures of U.S. and Israeli corporations and state and local governments. Management believes that those corporations and governments are institutions that are financially sound and that minimal credit risk exists with respect to these types of marketable securities.

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

n. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year. Diluted net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year, plus dilutive common stock equivalents related to outstanding stock options, non-vested restricted stock, warrants and convertible debt. All common stock equivalents have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding common stock equivalents excluded from the calculations of diluted net loss per share was 1,265,649 and 1,387,014 for the years ended December 31, 2010 and 2009, respectively.

o. Accounting for stock-based compensation

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

The Company did not grant any options in 2010 or 2009. The Company assumed a 20% forfeiture rate on existing options for both years. The Company typically uses a 5% forfeiture rate for stock and restricted stock units and adjusts both forfeiture rates based on historical forfeitures. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock.

p. Fair value of financial instruments:

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

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

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

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

The Company uses the Black-Scholes valuation model and other factors to determine the fair value of the warrants, the value of the embedded conversion feature and the value of the embedded put options associated with the Company's Senior Convertible Notes. (Level 3 – see Note 13)

q. Severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of em-

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ployment as of the balance sheet date. Israeli employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability for all of its Israeli employees is fully provided by monthly deposits with severance pay funds, insurance policies and by accrual. The fair value of these funds, which are considered Level 2, is recorded as an asset in the Company's balance sheet.

In addition, according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. As of December 31, 2010, the Company had made a provision of $2,355,682 for this special severance pay. As of December 31, 2010 and 2009, the unfunded severance pay in that regard amounted to $974,402 and $857,624, respectively.

Pursuant to the terms of the respective employment agreements between the Company and its Chief Executive Officer and its Chief Operating Officer, funds to secure payment of their respective contractual severance amounts are to be deposited for their benefit, with payments to be made pursuant to an agreed-upon schedule. These funds continue to be owned by the Company, which benefits from all gains and bears the risk of all losses resulting from investments of these funds.

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

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

Severance expenses for the years ended December 31, 2010 and 2009 amounted to $190,771 and $61,107, respectively.

r. Advertising costs:

The Company records advertising costs as incurred. Advertising expense for the years ended December 31, 2010 and 2009 was approximately $161,459 and $87,955, respectively.

s. New accounting pronouncements:

In October 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2009-13, "Revenue Recognition (Accounting Standards Codification ("ASC") 605) – Multiple-Deliverable Revenue Arrangements" and ASU 2009-14, "Software (ASC 985) – Certain Revenue Arrangements That Include Software Elements." ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: i) VSOE or ii) third-party evidence ("TPE"), before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. Additionally, ASU 2009-14 provides guidance on how a vendor should allocate arrangement considera-

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

tion to deliverables in an arrangement that includes both tangible products and software that is not essential to the product's functionality. ASU 2009-14 requires the same expanded disclosures that are included within ASU 2009-13. These new updates are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is required to adopt the amendments in both ASU 2009-13 and ASU 2009-14 in the same period using the same transition method. Early adoption is permitted. The Company is currently evaluating both the timing and the impact of the pending adoption of these ASU's on its consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." This Update is intended to provide financial statement users with additional information to assist them in assessing credit risk exposures and the adequacy of the allowance for credit losses. ASU 2010-20 is effective for interim and annual reporting periods ending on and after December 15, 2010. The standard became effective for the Company starting in December 2010 and the impact of adoption did not have a significant impact on its consolidated financial statements.

No other new accounting pronouncements issued or effective during 2010 have had or are expected to have a significant impact on the Company's consolidated financial statements.

t. Share repurchase:

In February 2009, the Company's Board of Directors authorized the repurchase in the open market or in privately negotiated transactions of up to $1.0 million of the Company's common stock. Through December 31, 2010, the Company repurchased 563,209 shares for a total of $757,148. The repurchase program is subject to management's discretion.

u. Reclassification:

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

NOTE 3: – RESTRICTED COLLATERAL DEPOSITS

	December 31, 2010	December 31, 2009
Deposits in connection with MDT projects	$ 169,354	$ 380,165
Deposits in connection with Epsilor projects	42,265	–
Deposits in connection with FAAC projects	1,630,524	1,617,000
Total restricted collateral deposits	$ 1,842,143	$ 1,997,165

NOTE 4: – AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2010 and 2009:

	Cost		Unrealized losses		Estimated fair value	
	2010	2009	2010	2009	2010	2009
Israeli government securities	$ 305,479	$ –	$ (2,315)	$ –	$ 303,164	$ –
Israeli bank securities	50,018	–	(785)	–	49,233	–
Israeli corporate securities	47,208	–	(156)	–	47,052	–
Available for sale marketable securities	$ 402,705	$ –	$ (3,256)	$ –	$ 399,449	$ –

NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31, 2010	December 31, 2009
Government authorities	$ 215,892	$ 321,630
Employees	59,513	62,643
Prepaid expenses	533,554	440,693
Loan to non-affiliated entity	–	2,000,000
Other	43,976	236
Total	$ 852,935	$ 2,825,202

Concurrent with a Securities Purchase Agreement dated August 14, 2008, the Company purchased a $2,500,000 Senior Subordinated Convertible Note from an unaffiliated company, DEI Services Corpora-

In U.S. dollars

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

tion ("DEI"). This 10% Senior Subordinated Convertible Note (the "DEI Note") was due December 31, 2009. The DEI Note was convertible at maturity at the Company's option into such number of shares of DEI's common stock, no par value per share, as would have been equal at the time of conversion to twelve percent (12%) of DEI's outstanding common stock.

In the third quarter of 2009, DEI repaid a portion of their internal shareholder loans, which was a violation of the DEI Note covenants with the Company. Because of this, the Company agreed in October of 2009 to amend the DEI Note to provide that the interest rate on the DEI Note would be increased to 15% and would be payable through the payment date. In the event that the DEI Note was not paid in full at maturity, the DEI Note would have been convertible into a minimum of 20% of DEI's then outstanding common stock, or more under certain circumstances.

In November 2009, DEI brought in a new investor that was prepared to provide DEI with additional working capital, but only if the Company agreed to step aside and accept a $500,000 discount on the DEI Note and waive its associated rights of first refusal and conversion. In view of the possibility that DEI would seek an extension of the DEI Note, the Company decided to enable DEI to bring in the new investor and thereby be able to pay the DEI Note on time, albeit at a discount. The Company accordingly wrote down the value of the DEI Note in the third quarter of 2009 by $500,000, to $2.0 million, and charged the associated expense to allowance for settlements on the statement of operations. When the new investor's investment did not close, the Company retained all its rights under the DEI Note, including its right to be paid the full amount of the DEI Note and its conversion option and right of first refusal.

On August 10, 2010, DEI repaid the entire $2.5 million principal amount of the DEI Note, along with all outstanding earned and unpaid interest. Inasmuch as the Company had previously established an allowance of $500,000 in the third quarter 2009 on the DEI Note based on the Company's expectation that the Company would not collect the entire DEI Note, the Company recognized the difference between the $2.0 million book value of the DEI Note and the $2.5 million that was actually collected as a recovery under allowance for settlements on the Company's financial statements. Additionally, the Company accrued unpaid interest on the DEI Note through June 30, 2010 in the amount of $140,000, which was recorded as a reduction of financial expenses and additionally recorded $11,000 in interest income in the third quarter of 2010. This transaction extinguished the Company's conversion options and rights of first refusal with respect to DEI.

NOTE 6:– INVENTORIES

	December 31, 2010	December 31, 2009
Raw and packaging materials	$ 7,693,001	$ 7,479,672
Work in progress	1,280,669	3,943,073
Finished products	680,339	912,292
Total	$ 9,654,009	$ 12,335,037

NOTE 7:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31, 2010	December 31, 2009
Cost:		
Computers and related equipment	$ 2,408,362	$ 2,293,941
Motor vehicles	513,971	508,199
Office furniture and equipment	1,224,539	1,228,694
Machinery, equipment and installations	5,170,083	4,618,750
Buildings	1,172,072	1,172,072
Land	115,538	115,538
Leasehold improvements	1,132,109	1,047,208
Demo inventory	1,808,571	1,607,948
	13,545,245	12,592,350

In U.S. dollars

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

	December 31, 2010	December 31, 2009
Accumulated depreciation:		
Computers and related equipment	2,160,511	2,010,768
Motor vehicles	107,405	163,632
Office furniture and equipment	967,675	873,151
Machinery, equipment and installations	3,753,970	3,232,669
Buildings	115,204	85,150
Leasehold improvements	818,019	724,992
Demo inventory	982,950	877,155
	8,905,734	7,967,517
Property and equipment, net	$ 4,639,511	$ 4,624,833

b. Depreciation expense amounted to $1,173,626 and $1,260,458 for the years ended December 31, 2010 and 2009, respectively.

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

As for liens, see Note 11.d.

NOTE 8:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

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

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

	December 31, 2009	Additions	Adjustments (currency)	December 31, 2010
Simulation	$24,435,641	$ –	$ –	$ 24,435,641
Battery	6,058,493	–	385,805	6,444,298
Armor	1,809,539	–	90,982	1,900,521
Total	$32,303,673	$ –	$ 476,787	$ 32,780,460

b. Other intangible assets:

		December 31, 2010		December 31, 2009	
	Useful life	Cost	Net book value	Cost	Net book value
Technology	4-8 years	$ 7,068,000	$ 955,107	$ 7,068,000	$ 1,626,071
Capitalized software costs	1-3 years	2,949,597	814,093	2,401,387	674,699
Trademarks	10 years	28,000	19,600	28,000	22,400
Backlog/customer relationship	1-10 years	744,000	43,400	744,000	49,600
Customer list	2-10 years	7,602,045	1,878,519	7,602,045	2,513,609
		18,391,642	$ 3,710,719	17,843,432	$ 4,886,379
Exchange differences		369,036		340,221	
Less - accumulated amortization		(14,680,924)		(12,957,053)	
Amortized cost		4,079,754		5,226,600	
Trademarks (indefinite lives)		799,000		799,000	
Net book value		$ 4,878,754		$ 6,025,600	

Subsequent to the 2004 purchase of AoA, the Company recorded an impairment charge in 2005 to fully impair related goodwill ($10.5 million) and intangible assets ($2.6 million). Additionally, due to an earnout on the same transaction, the Company recorded an additional $316,000 in goodwill in 2007 and immediately recorded an impairment of $316,000. The Company has not recorded any other goodwill impairment charges.

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

Amortization expense amounted to $1,723,871 and $1,458,802 for the years ended December 31, 2010 and 2009, respectively, including amortization of capitalized software costs of $408,817 and $106,105, respectively.

c. Estimated amortization expenses for the years ended:

Year ended December 31,	
2011	$ 1,911,073
2012	942,553
2013	726,378
2014	103,715
2015 and forward	27,000
Total	$ 3,710,719

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

NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS

The Company has $10.6 million authorized in credit lines from certain banks, of which $560,000 is denominated in NIS (none outstanding as of December 31, 2010) and carries various approximate interest rates of prime rate + 4.3% and $10.0 million is denominated in U.S. dollars (the Company's primary line which expires in December 2011) and carries an interest rate of lender's prime rate + 0.5% which was 3.75% as of December 31, 2010. As of December 31, 2010, $2.5 million was borrowed under the Company's primary line and an additional $775,000 was committed to four letters of credit issued to customers and vendors of the Company. The Company had an additional $1.6 million letter of credit that does not impact the borrowing base as it is collateralized by $1.6 million in restricted collateral deposits. Approximately $3.3 million of credit on the primary line, based on the Company's borrowing base calculations, was available at December 31, 2010. The main credit facility includes covenants restricting the Company's Total Senior Liabilities to Tangible Net Worth and Funded Debt to EBITDA (all as defined in the credit agreement) along with a limitation on cash distributions to Arotech affiliated companies. As of December 31, 2010, the Company was in compliance with all covenants.

These lines of credit are collateralized by the accounts receivable and inventory of the relevant subsidiary of the Company.

NOTE 10:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2010	**2009**
Employees and payroll accruals	$ 2,949,222	$ 2,696,018
Accrued vacation pay	733,780	711,373
Accrued expenses	2,096,608	1,744,469
Government authorities	657,652	107,832
Advances from customers	90,085	979,744
Total	$ 6,527,347	$ 6,239,436

NOTE 11:– COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

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. (Amounts due in respect of projects approved after 1999 also bear interest at the Libor rate.) EFL is obligated to pay royalties only on sales of products in respect of which OCS participated in their development. Should the project fail, EFL will not be obligated to pay any royalties or refund the grants.

In U.S. dollars

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

Royalties paid or accrued for the years ended December 31, 2010 and 2009 to the OCS amounted to $17,992 and $19,832, respectively.

b. Lease commitments:

The Company rents its facilities under various operating lease agreements, which expire on various dates through 2018. The minimum rental payments under non-cancelable operating leases are as follows:

Minimum rental payments	December 31
2011	$ 1,093,822
2012	861,191
2013	687,891
2014	339,983
2015	329,983
Thereafter	640,357
Total	$ 3,953,227

Total rent expenses for the years ended December 31, 2010 and 2009 were $1,015,189 and $835,370, respectively.

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

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

Leased Assets	December 31,	
	2010	2009
Equipment	$ 135,654	$ 206,564
Less: Accumulated depreciation	(86,060)	(85,058)
Net book value	$ 49,594	$ 121,506

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

Liabilities	December 31, 2010
Obligations under capital leases:	
Current	$ 46,950
Non-current	12,407
Total minimum payments	59,357
Less: Interest	8,627
Present value of payments	$ 50,730

The table below details the future lease payments due as of December 31, 2010.

Future Minimum Lease Payments	December 31,
2011	$ 46,950
2012	11,906
2013	501
Total minimum lease payments	$ 59,357

c. Guarantees:

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

d. Liens:

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

The Company has $1.9 million in credit liens collateralized by the assets of the Company and guaranteed by the Company.

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

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

e. Litigation and other claims:

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

1. NAVAIR Litigation:

On January 10, 2011, a judgment and decision was unsealed and issued for publication in respect of the lawsuit in the United States Court of Federal Claims by AoA against the United States Naval Air Systems Command (NAVAIR). The lawsuit, which was based on events that had occurred prior to Arotech's purchase of AoA, had sought approximately $2.2 million in damages for NAVAIR's alleged improper termination of a contract for the design, test and manufacture of a lightweight armor replacement system for the United States Marine Corps CH-46E rotor helicopter. NAVAIR, in its answer, counterclaimed for approximately $2.1 million in alleged reprocurement and administrative costs. The court's decision found against AoA and in favor of NAVAIR, and awarded NAVAIR reprocurement and administrative costs in the total amount of approximately $1.55 million. The Company has filed a notice of appeal in respect of a substantial portion of the court's decision.

Based on the trial results and subsequent inquiries, the Company, after consultation with litigation counsel handling this case and with its advisors, had previously formed a conclusion that it would be appropriate and prudent to record an allowance in anticipation of an adverse decision in this case, in the amount of $750,000, and had recorded a charge in this amount in its financial statements for the year ended December 31, 2009. In light of the judge's decision in this case, the Company recorded an additional charge of approximately $803,000 in its financial statements for the year ended December 31, 2010.

The Company does not believe that this judgment will adversely affect its current business relationship with NAVAIR, with which various of its subsidiaries have conducted business subsequent to the events that formed the basis of this lawsuit.

1. Class Action Litigation:

In May 2007, two purported class action complaints (the "Class Action Complaint") were filed in the United States District Court for the Eastern District of New York against the Company and certain of our officers and directors. These two cases were consolidated in June 2007. In January 2010, the Company reached an agreement with lead plaintiffs to settle the Class Action Complaint. This agreement, providing for settlement of all claims for a monetary payment of $2.9 million funded entirely from insurance proceeds, was approved by the District Court on June 23, 2010, and accordingly the lawsuit was dismissed with prejudice, and the Company and all of the Company's current and former officers and directors named in the complaint have received a full and complete release of all claims asserted against us and them in the litigation, as well as any related claims that could have been asserted.

Additionally, on May 6, 2009 a purported shareholders derivative complaint (the "Derivative Complaint") was filed in the United States District Court for the Eastern District of New York against the Company and certain of the Company's officers and directors. The Derivative Complaint is based on the same facts as the recently settled class action litigation against the Company in the same district, and primarily relates to the Company's acquisition of AoA in 2005 and certain public statements made by the Company with respect to its business and prospects during the period between March 31, 2005 and November 14, 2005. The Derivative Complaint seeks an unspecified amount of damages. The Company moved for dismissal of the Derivative Complaint in March 2010, and oral arguments on the Companies motion were heard in September 2010.

Although the ultimate outcome of this matter cannot be determined with certainty, the Company believes that the allegations stated in the Derivative Complaint are without merit and the Company and the Company's officers and directors named in the Derivative Complaint intend to defend the Company vigorously against such allegations.

In U.S. dollars

NOTE 12:– CONVERTIBLE DEBT AND OTHER LONG TERM DEBT

a. Subordinated convertible notes due August 15, 2011

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

The Company primarily made the principal payments in cash, although a portion of certain principal payments was paid in stock, at the request of one of the Note holders, by the Note holder's conversion of a portion of the quarterly principal payment due for that quarter. Further payments are due in February, May and August 2011. In the event the Company elects to make payments of principal on its Notes in stock by requiring the holders to convert a portion of their Notes, either because its cash position at the time makes it necessary or it otherwise deems it advisable, the price used to determine the number of shares to be issued on conversion will be calculated using an 8% discount to the average trading price of the Company's common stock during 17 of the 20 consecutive trading days ending two days before the payment date. Accordingly, the lower the market price of the Company's common stock at the time at which it makes payments of principal in stock, the greater the number of shares the Company will be obliged to issue and the greater the dilution to its existing stockholders. This pricing method is also used by the Note holders when all or a portion of the Notes are converted voluntarily.

	As of December 31,	
Convertible notes	**2010**	**2009**
Principal balance	$ 1,363,635	$ 3,181,820
Debt discount balance	39,351	202,144

Debt discount is amortized over the term of the note using the effective interest method. $1,363,635 is due in 2011.

The Company can require the holder of its Notes to convert a portion of their Notes into shares of the Company's common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. Embedded in the Notes are put options associated with potential defaults, change in control and not meeting certain equity conditions along with a call option available to the Company.

The Notes include certain customary restrictive covenants and rights upon an event of default. The events of default includes suspension of trading, failure to cure a conversion failure, failure to timely make principal and interest payments, defaults on other credit arrangements, bankruptcy, judgments in excess of $1.0 million not resolved within sixty days and generally any uncured breach of the Notes.

Contemporaneously with the signing of a securities purchase agreement for the above Notes, the Company also executed a Registration Rights Agreement. This agreement required the registration of additional shares of the Company and that the registration statement, which was declared effective in 2008, remains effective throughout the term of the Notes. If it were to cease to be effective for any reason, the Company would owe the Note holders 1.5% of the remaining principal amount of the Notes for each month that the registration statement was not effective. Additional requirements of this agreement require the Company to, among other things, abide by all rules and regulations of the SEC and timely file all required reports. As of December 31, 2010, the Company was in compliance with all requirements of this agreement.

b. Mortgage Note, Auburn, Alabama:

In March 2007, the Company purchased space in Auburn, Alabama for approximately $1.1 million pursuant to a seller-financed secured purchase money mortgage. Half the mortgage is payable over ten years in equal monthly installments based on a 20-year amortization of the full principal amount, and the re-

In U.S. dollars

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

maining half is payable at the end of ten years in a balloon payment. The note requires a payment (principal and interest) of approximately $9,300 per month at an interest rate of 8% per annum. The balance of this note is shown in the short and long term sections of the balance sheet.

Mortgage - Future Principal Payments	December 31,
2011	$ 31,772
2012	34,423
2013	37,287
2014	40,382
2015	43,734
Thereafter	828,696
	$ 1,016,294

The Company has additional long term debt outstanding of approximately $100,000, primarily vehicle loans. This amount is payable through 2012.

NOTE 13:– STOCKHOLDERS' EQUITY

a. Stockholders' rights:

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

b. Warrants:

As part of a securities purchase agreement entered into in August 2008, the Company issued to the purchasers of the Notes, warrants to purchase an aggregate of 558,036 shares of common stock at any time prior to August 15, 2011 at a price of $2.24 per share. The warrants were originally classified as equity based on their relative fair value of $412,300, which was also recorded as a debt discount and none of the warrants have been exercised as of December 31, 2010.

On January 1, 2009, the Company adopted FASB ASC 815-40-15, "Determining Whether an Instrument is Indexed to an Entity's Own Stock." FASB ASC 815-40-15 required the Company to re-evaluate the warrants issued with the convertible notes and to also re-evaluate the embedded conversion option and embedded put options within the Notes to determine if the previous accounting for these items would change. Since the exercise price of both the convertible notes and the warrants can be reset under certain conditions, the Company determined that the warrants would be considered a liability. Upon this re-evaluation, the Company was required to record a cumulative adjustment as of January 1, 2009 that included reclassifying the warrant value previously included in stockholders' equity ($412,300) to other liabilities, reflecting the value of the embedded conversion feature as additional debt discount and as other liabilities as of the debt issuance date ($59,001), increasing financial expenses due to the larger debt discount and increasing financial expenses to reflect the change in the value of the warrants and the conversion features from the debt issuance date to December 31, 2008. The aggregate additional 2008 expense of $471,301 was recorded as an adjustment to beginning accumulated deficit as of January 1, 2009.

The fair value of these warrants was determined as of August 15, 2008 using a Black-Scholes pricing model and other factors, assuming a risk-free interest rate of 2.78%, a volatility factor 75%, dividend yields of 0% and a contractual life of 3.0 years.

On December 31, 2010 and 2009, the Company revalued these warrants, the embedded conversion option and the embedded put options. The 2010 credit to financial expense associated with this revaluation is approximately $233,000 and the 2009 financial expense was approximately $342,000. The table below lists the variables used in the Black-Scholes calculation and the resulting values.

Variables	January 1, 2009	December 31, 2009	December 31, 2010
Stock price	$ 0.41	$ 1.70	$ 1.67
Risk free interest rate	1.00%	1.70%	1.02%
Volatility	81.40%	79.85%	76.90%
Dividend yield	0.00%	0.00%	0.00%

In U.S. dollars

NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

Contractual life	2.6 years	1.6 years	0.6 years
Values	**January 1, 2009**	**December 31, 2009**	**December 31, 2010**
Warrants	$ 29,171	$ 298,570	$ 131,355
Conversion option	8,013	88,156	28,822
Puts	14,997	7,371	1,162
Total value	$ 52,181	$ 394,097	$ 161,339

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

1. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 537,173 were available for future grants to outside directors as of December 31, 2010.

2. 2009 Equity Incentive Plan – 5,000,000 shares reserved for issuance, of which 4,181,666 were available for future grants to employees and consultants as of December 31, 2010.

3. Under these plans, options generally expire no later than 5-10 years from the date of grant. Each option can be exercised to purchase one share, conferring the same rights as the other common shares. Options that are cancelled or forfeited before expiration become available for future grants. The options generally vest over a three-year period (33.3% per annum) and restricted shares and restricted stock units also generally vest after three years or pursuant to defined performance criteria; in the event that employment is terminated within that period, unvested restricted shares and restricted stock units generally revert back to the Company.

4. Deferred stock compensation is amortized and recorded as compensation expense ratably over the vesting period of the option or the restriction period of the restricted shares and restricted stock units. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options, restricted shares and restricted stock units to employees and directors in 2010 and 2009 was $741,559 and $849,272, respectively. The calculated intrinsic value of vested and unvested options for 2010 and 2009 was zero.

5. A summary of the status of the Company's plans and other share options, restricted shares and restricted stock units granted as of December 31, 2010 and 2009, and changes during the years ended on those dates, is presented below:

Stock Options:

	2010		**2009**	
	Amount	**Weighted average exercise price**	**Amount**	**Weighted average exercise price**
Options outstanding at beginning of year	218,921	$ 6.23	236,906	$ 6.14
Changes during year:				
Granted	–	$ –	–	$ –
Exercised	–	$ –	–	$ –
Forfeited	(32,207)	$ 5.46	(17,985)	$ 5.10
Options outstanding at end of year	186,714	$ 6.36	218,921	$ 6.23
Options vested at end of year	186,714	$ 6.36	218,921	$ 6.23
Options expected to vest	–	$ –	–	$ –

In U.S. dollars

NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

Restricted Shares and Restricted Stock Units:

	2010		2009	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
Non-vested at the beginning of the year	747,539	$ 1.68	713,313	$ 2.41
Changes during year:				
Restricted stock granted	383,572	$ 1.67	412,622	$ 1.46
Restricted units granted	130,000	$ 1.67	77,917	$ 1.67
Vested	(505,965)	$ 1.66	(439,578)	$ 2.18
Forfeited	(348,333)	$ 2.35	(16,735)	$ 2.89
Non-vested at the end of the year	406,813	$ 1.60	747,539	$ 1.68
Restricted shares vested at end of year	1,738,890	$ 2.18	1,232,925	$ 2.40

6. The options outstanding as of December 31, 2010 have been separated into ranges of exercise price, as follows:

	Total options outstanding			Vested options outstanding	
Range of exercise prices	Amount outstanding at December 31, 2010	Weighted average remaining years contractual life	Weighted average exercise price	Amount exercisable at December 31, 2010	Weighted average exercise price
0.00-4.99	94,000	0.97	$ 2.77	94,000	$ 2.77
5.00-9.99	57,714	2.07	$ 6.16	57,714	$ 6.16
10.00-34.99	35,000	1.30	$ 16.36	35,000	$ 16.36
Total	186,714	1.37	$ 6.36	186,714	$ 6.36

7. Options issued to consultants:

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

	2010		2009	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
Options outstanding at beginning of year	7,317	$ 68.24	7,317	$ 68.24
Changes during year:				
Granted	–	–	–	–
Exercised	–	–	–	–
Forfeited or retired	(7,317)	$ 68.24	–	–
Options outstanding at end of year	–	$ –	7,317	$ 68.24
Options vested at end of year	–	$ –	7,317	$ 68.24

In connection with the grant of stock options to consultants, the Company did not recognize any expenses for the years ended December 31, 2010 and 2009 and all consultant options were retired in 2010.

8. The remaining total compensation cost related to non-vested stock options, restricted share and restricted stock unit awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2010 was $140,598, of which zero was for stock options and $140,598 was for restricted shares and restricted stock units. The weighted average period over which this compensation cost is expected to be recognized is approximately two years.

9. On January 1, 2009 the Company adopted FASB ASC 260-45-28, Share-Based Payment Arrangements, which classifies unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) as participating securities and requires them to be included in the computation of diluted earnings per share using the two class method. The Company has determined that the unvested restricted stock issued to our employees and directors are

In U.S. dollars

NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

"participating securities" and as such, are included, net of estimated forfeitures, in the total shares used to calculate the Company's diluted loss per share but not the basic loss per share as they are anti-dilutive.

d. Dividends:

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

NOTE 14:– INCOME TAXES

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

As of December 31, 2010, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately $23.4 million, which are available to offset future taxable income, if any, expiring in 2011 through 2029. Utilization of U.S. net operating losses is subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

At December 31, 2010, the Company had net deferred tax assets of $37.3 million. The deferred tax assets are primarily composed of federal, state and foreign tax net operating loss ("NOL") carryforwards. Due to uncertainties surrounding the Company's ability to generate future taxable income to realize these assets, a full valuation of the U.S. tax assets has been established to offset its net deferred tax asset. Additionally, the future utilization of the Company's NOL carryforwards to offset future taxable income is subject to a substantial annual limitation as a result of ownership changes that have occurred. The Company completed an IRS Section 382 analysis in 2007 regarding the limitation of the net operating losses and determined that the maximum amount of U.S. federal NOL available as of January 1, 2007 was $18,851,605, compared to the amount shown on the tax return of $31,161,945. The related Deferred Tax Asset and corresponding valuation allowance were reduced by $4,185,516 for the U.S. federal NOLs and by $3,555,231 for the state NOLs.

The Company has also reevaluated the unrecognized tax benefits under this standard as of December 31, 2010 after the completion of the Section 382 review. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in the Company's unrecognized tax benefits will not impact the Company's effective tax rate.

The Company has indefinitely-lived intangible assets consisting of trademarks and goodwill. These indefinitely-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these indefinitely-lived intangible assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a "naked tax credit." This deferred tax liability could remain on the Company's balance sheet indefinitely unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

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

The Company files income tax returns, including returns for its subsidiaries, with federal, state, local and foreign jurisdictions. The Company is no longer subject to IRS examination for periods prior to 2008, although carryforward losses that were generated prior to 2008 may still be adjusted by the IRS if they are used in a future period. Additionally, the Company is no longer subject to examination in Israel for periods prior to 2005.

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

NOTE 14:– INCOME TAXES (Cont.)

b. Israeli subsidiary (Epsilor):

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

Currently, Epsilor is operating under two programs, as follows:

1. Program one:

Epsilor's first expansion program (No. 6585) of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law, and will be entitled to investment grants from the State of Israel in the amount of 24% on property and equipment located at its Dimona plant.

The expansion program is in the amount of approximately $945,000. This program has received final approval and is funded, up to the amount of the grant, as property and equipment is purchased.

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the program began operations, or 14 years from the year in which the approval was granted, whichever is earlier.

The main tax benefits available to Epsilor are reduced average tax rates.

2. Program two:

Epsilor's second expansion program (No. 9054) of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law, and will be entitled to investment grants from the State of Israel in the amount of 24% on property and equipment located at its Dimona plant.

The expansion program is in the amount of approximately $1,100,000. This program has not yet received final approval and so no funds have been received under this grant.

Taxable income derived from the approved enterprise is subject to a reduced tax rate during seven years beginning from the year in which taxable income is first earned (tax exemption for the first two-year period and 25% tax rate for the five remaining years).

Those benefits are limited to 12 years from the year that the program began operations, or 14 years from the year in which the approval was granted, whichever is earlier.

The main tax benefits available to Epsilor are reduced average tax rates.

c. Additional Approved Enterprise information::

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

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 25% in 2010, 24% in 2011 and 23% in 2012.

If retained tax-exempt profits attributable to the "approved enterprise" are distributed, they would be taxed at the corporate tax rate applicable to such profits as if Epsilor had not elected the alternative system of benefits, currently 25% for an "approved enterprise."

Dividends paid from the profits of an approved enterprise are subject to tax at the rate of 15% in the hands of their recipient. As of December 31, 2010, there are no tax exempt profits earned by Epsilor's "approved enterprises" by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2010. Furthermore, management has indicated that it has no intention of declaring any dividend.

On April 1, 2005, an amendment to the Investment Law came into effect (the "Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export.

NOTE 14:– INCOME TAXES (Cont.)

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the existing Approved Enterprise of the Israeli subsidiaries (program one) will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Amended Investment Law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2010, the Company did not generate income under the provision of the amended Investment Law.

d. Merger of Epsilor and EFL:

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

The primary purpose of the merger is to enable a unity of management and business operation of the two companies, while achieving a substantial cost savings and creating a competitive advantage in the marketplace in which these companies operate.

On March 10, 2010, the Israeli tax authorities agreed to pre-approve an agreed tax treatment for this merger, subject to the following conditions:

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

Also, to the extent that the changed structure results in tax benefits under the Investments Law, such benefits will be available to the Merged Company only to the extent that the directorate of the Investment Center of the Israel Ministry of Trade gives an additional approval pursuant to the provisions of Article 74 of the Investments Law; such an additional approval was received from the Investment Center on November 11, 2010. Receipt of the aforementioned tax benefits after the merger is conditional upon the maintenance of separate accounts for EFL's and Epsilor's taxable income even after the merger.

Epsilor has reversed a portion of the previous valuation allowance for the implied tax benefit of the tax losses to be transferred in the coming years in the amount of $613,000. As of December 31, 2010, the merged company has a tax loss carryforwards of approximately $95.7 million, which is available to offset future taxable income.

Under the Law for the Encouragement of Industry (Taxation), 1969, EFL and Epsilor are "industrial companies," as defined by this law and, as such, are entitled to certain tax benefits, mainly accelerated depreciation, as prescribed by regulations published under the inflationary adjustments law, the right to claim amortization of know-how, patents and certain other intangible property rights as deductions for tax purposes. Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 25% in 2010, 24% in 2011 and 23% in 2012.

e. Consolidated deferred income taxes:

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

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

Significant components of deferred tax assets

	December 31, 2010	December 31, 2009
U.S. operating loss carryforward	$ 9,448,03	$ 8,538,66
Foreign operating loss carryforward	22,470,029	26,419,889
Total operating loss carryforward	31,918,059	34,958,554
Temporary differences:		
Compensation and benefits	1,923,1	1,872,4
Warranty reserves	1,278,0	687,
Foreign temporary differences	790,	1,048,4
All other temporary differences	1,368,4	2,334,2
Total temporary differences	5,360,4	5,942,9
Net deferred tax asset before valuation allowance	37,278,528	40,901,527
Valuation allowance	(36,626,236)	(40,860,122)
Total deferred tax asset	$ 652,292	$ 41,405
Deferred tax liability	$ 3,315,000	$ 2,990,000

The entire deferred tax liability represents the required adjustment of taxes due to the deduction of goodwill "naked" credits for U.S. federal taxes ("naked" credits occur when deferred tax liabilities that are created by indefinite-lived assets such as goodwill cannot be used as a source of taxable income to support the realization of deferred tax assets).

The Company has not recorded any deferred taxes on the cumulative undistributed earnings of other non-U.S. subsidiaries because the earnings are intended to be indefinitely re-invested in those operations, and it is not practicable for the Company to compute such tax. Accrued income taxes on the undistributed earnings of domestic subsidiaries and affiliates are not provided because dividends received from domestic companies are expected to be non-taxable.

The Company provided valuation allowances for a portion of the deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax assets related to the U.S. loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance during 2010 was $4.2 million.

f. Profit (loss) before taxes on income are as follows:

	Year ended December 31, 2010	Year ended December 31, 2009
Domestic	$ 1,007,786	$ (2,300,061)
Foreign	(2,043,505)	51,218
	$ (1,035,719)	$ (2,248,843)

g. Taxes on income were comprised of the following:

	Year ended December 31, 2010	Year ended December 31, 2009
Current federal taxes	$ 62,292	$ –
Current state and local taxes	32,656	252,426
Deferred taxes	(283,179)	590,709
Taxes in respect of prior years	69,731	(38,169)
Expense (benefit)	$ (118,500)	$ 804,966
Domestic	$ 438,467	$ 776,040
Foreign	(556,967)	28,926
Expense (benefit)	$ (118,500)	$ 804,966

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

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

	Year ended December 31, 2010	Year ended December 31, 2009
Loss before taxes, as reported in the consolidated statements of operations	$(1,035,719)	$(2,248,843)
Statutory tax rate	34%	34%
Theoretical income tax on the above amount at the U.S. statutory tax rate	$ (352,144)	$ (764,607)
Deferred taxes for which valuation allowance was provided	(93,749)	1,161,957
Non-deductible credits (expenses)	(21,201)	162,650
Foreign non-deductible expenses	–	72,800
State taxes, net of federal benefit	32,656	216,040
Foreign income in tax rates other than U.S rate	183,915	(11,196)
Taxes in respect of prior years	69,731	(38,169)
Alternative minimum tax for which a valuation allowance was provided	62,292	–
Others	–	5,491
Actual tax expense (benefit)	$ (118,500)	$ 804,966

NOTE 15:– SELECTED STATEMENTS OF OPERATIONS DATA

Financial expenses, net:

	Year ended December 31, 2010	Year ended December 31, 2009
Financial expenses:		
Interest, bank charges and fees	$ (669,806)	$ (715,606)
Debt discount and warrant amortization	(162,793)	(662,417)
Foreign currency transaction differences	(26,622)	(129,468)
Other	(47,722)	–
Total financial expenses	(906,943)	(1,507,491)
Financial income:		
Interest	272,784	243,212
Foreign currency transaction differences	262,915	–
Warrant valuation credit	232,758	–
Other	31,219	12,894
Total financial income	799,676	256,106
Total financial expenses, net	$ (107,267)	$ (1,251,385)

NOTE 16:– SEGMENT INFORMATION

a. General:

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

The Company's reportable operating segments have been determined in accordance with the Company's internal management structure, which is organized based on operating activities. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based 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.

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

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

	Training and Simulation Division	Battery and Power Systems Division	Armor Division	Corporate	Total Company
2010					
Revenues from outside customers	$ 35,562,297	$ 18,675,517	$19,503,664	$ –	$ 73,741,478
Depreciation , amortization and impairment expenses [1]	(1,597,702)	(1,042,600)	(170,150)	(87,045)	(2,897,497)
Direct expenses [2]	(29,601,497)	(17,052,537)	(19,277,989)	(6,159,668)	(71,535,433)
Segment net income (loss)	4,363,098	1,136,638	55,525	(6,246,713)	(691,452)
Financial income (expenses)	(7,264)	93,670	(246,471)	52,798	(107,267)
Income tax expense (credits)	48,467	93,670	(246,471)	52,798	(107,267)
Net income (loss)	$ 4,404,301	$ 674,050	$ (191,655)	$ (5,803,915)	$ (917,219)
Segment assets	$ 44,604,746	$ 26,029,719	$ 8,546,620	$ 4,455,854	$ 83,636,939
Additions to long-lived assets	$ 1,018,813	$ 773,193	$ 69,326	$ 8,830	$ 1,870,162
2009					
Revenues from outside customers	$ 39,206,173	$ 17,820,980	$17,507,298	$ –	$ 74,534,451
Depreciation , amortization and impairment expenses [1]	(1,327,231)	(1,031,304)	(181,657)	(179,068)	(2,719,260)
Direct expenses [2]	(33,122,447)	(16,890,781)	(17,122,806)	(7,286,547)	(74,422,581)
Segment net income (loss)	4,756,495	(101,105)	202,835	(7,465,615)	(2,607,390)
Financial expenses	(1,342)	(70,819)	(214,042)	(965,182)	(1,251,385)
Income tax expense (credits)	(7,264)	93,670	(246,471)	52,798	(107,267)
Net income (loss)	$ 4,938,774	$ (142,998)	$ (36,881)	$ (7,812,704)	$ (3,053,809)
Segment assets	$ 45,933,659	$ 23,618,194	$12,432,348	$ 2,133,678	$ 84,117,879
Additions to long-lived assets	$ 1,030,944	$ 312,775	$ 223,516	$ 8,025	$ 1,575,260

(1) Includes depreciation of property and equipment and amortization expenses of intangible assets.
(2) Including, *inter alia*, sales and marketing, general and administrative, research and development, allowance for settlements and other income.

c. Summary information about geographic areas:

The following presents total revenues according to the locations of the Company's end customers and long-lived assets for the years ended December 31, 2010 and 2009:

	2010		2009	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets
U.S.A.	$ 56,495,919	$ 30,628,970	$54,960,149	$ 31,216,469
Israel	11,010,352	11,669,755	9,947,724	11,737,637
Taiwan	2,170,447	–	204,098	–
Canada	618,710	–	278,535	–
England	495,465	–	527,405	–
Germany	317,702	–	552,208	–
Australia	300,145	–	–	–
China	227,811	–	–	–
Hong Kong	181,838	–	–	–
Mexico	169,891	–	–	–
India	165,594	–	1,200,711	–
Spain	164,210	–	–	–
Singapore	133,656	–	1,804,992	–
Japan	33,355	–	3,228,035	–
Trinidad	–	–	368,562	–
Other	1,256,383	–	1,462,032	–
	$ 73,741,478	$42,298,725	$74,534,451	$42,954,106

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

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

	Year ended December 31,	
	2010	2009
Training and Simulation:		
Customer A	18%	32%
Battery and Power Systems:		
Customer B	4%	4%
Customer C	4%	5%
Armor:		
Customer D	20%	13%
Customer E	4%	5%

During 2010 and 2009, including all of our divisions, various branches of the United States military accounted for approximately 42% and 50% of our revenues, respectively.

e. Revenues from major products:

	Year ended December 31,	
	2010	2009
Water activated batteries	$ 3,483,779	$ 2,484,217
Batteries and chargers	15,191,738	15,336,763
Car, aircraft and other armoring	19,503,664	17,507,298
Simulators	35,562,297	39,206,173
Total	$ 73,741,478	$ 74,534,451

NOTE 17:– ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income consists of currency translation adjustments of $2,143,000 and $1,537,000 at December 31, 2010 and 2009, respectively, and unrealized losses on marketable securities of $3,000 and zero at December 31, 2010 and 2009, respectively.

NOTE 18:– AFFILIATED COMPANIES

The Company has an investment in an affiliated company, Concord Safety Solutions, Pvt. Ltd. (26% ownership), which is accounted for under the equity method of accounting. The Company’s interest in the net losses of the affiliated company totaled zero in 2010 and 2009, respectively.

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FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2010 and 2009

Description	Balance at beginning of period	Reductions	Additions	Balance at end of period
Year ended December 31, 2010				
Allowance for doubtful accounts..........................	$ 47,000	$ –	$ –	$ 47,000
Allowance for settlements	1,250,000	(500,000)	803,000	1,553,000
Valuation allowance for deferred taxes*.............	40,860,000	(4,234,000)	–	36,626,000
Year ended December 31, 2009				
Allowance for doubtful accounts..........................	$ 19,000	$ –	$ 28,000	$ 47,000
Allowance for settlements	–	–	1,250,000	1,250,000
Valuation allowance for deferred taxes*.............	37,781,000	–	3,079,000	40,860,000

*The 2010 and 2009 valuation allowance includes an adjustment to the prior year provision calculation due to changes recognized in the preparation of the actual returns.

AROTECH DIRECTORS

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

Edward J. Borey, Director
Consultant

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

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

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

Michael Marrus, Director
Investment Banker

Elliot Sloyer, Director
Managing Member,
WestLane Capital Management LLC

Arthur S. Leibowitz, Director
Lecturer, Department of Accounting, Finance and Economics
Adelphi University School of Business

AROTECH CORPORATE OFFICERS

Robert S. Ehrlich
Chairman and Chief Executive Officer

Steven Esses
President and Chief Operating Officer

Dean Krutty
President, Training and Simulation Division

Jonathan Whartman
President, Armor Division

Ronen Badichi
President, Battery and Power Systems Division

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

Thomas J. Paup
Vice President – Finance and CFO

Norman Johnson
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Monday, September 12, 2011, at 10:00 a.m. local time at the offices of Lowenstein Sandler P.C., 1251 Avenue of the Americas, 18th Floor, New York, New York.

Stock Transfer Agent

American Stock Transfer & Trust Company, 59 Maiden Lane, Plaza Level, New York, New York 10038.

Shares Traded

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

Forms 10-K

Our Annual Report on Form 10-K provides additional information and is on file with the Securities and Exchange Commission. It is available free of charge upon written request to Stockholder Relations, Arotech Corporation, 1229 Oak Valley Drive, Ann Arbor, Michigan 48108.

Website

Our corporate website is at **http://www.arotech.com**. Reference to our website does not constitute incorporation of any of the information thereon into this annual report.

www.arotech.com

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