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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K/A  
(Amendment No. 1)**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007.

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.

Commission File Number: 0-23336

**AROTECH CORPORATION**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

95-4302784  
(I.R.S. Employer Identification No.)

1229 Oak Valley Drive, Ann Arbor, Michigan  
(Address of principal executive offices)

48108  
(Zip Code)

(800) 281-0356  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class  
**Common Stock, \$0.01 par value**

Name of each exchange on which registered  
**The Nasdaq Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, \$0.01 par value**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer:  Accelerated filer:  Non-accelerated filer:  Smaller reporting company:  S

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the registrant's voting stock held by non-affiliates of the registrant as of June 30, 2007 was approximately

\$40,382,408 (based on the last sale price of such stock on such date as reported by The Nasdaq Global Market and assuming, for the purpose of this calculation only, that all of the registrant's directors and executive officers are affiliates).

*(Applicable only to corporate registrants)* Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

**13,599,197 as of 3/31/08**

Documents incorporated by reference:

**None**

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### **PRELIMINARY NOTE**

This annual report contains historical information and forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to our business, financial condition and results of operations. The words “estimate,” “project,” “intend,” “expect” and similar expressions are intended to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward-looking statements. Further, we operate in an industry sector where securities values may be volatile and may be influenced by economic and other factors beyond our control. In the context of the forward-looking information provided in this annual report and in other reports, please refer to the discussions of risk factors detailed in, as well as the other information contained in, our other filings with the Securities and Exchange Commission.

Electric Fuel<sup>®</sup> is a registered trademark and Arotech<sup>™</sup> is a trademark of Arotech Corporation, formerly known as Electric Fuel Corporation. All company and product names mentioned may be trademarks or registered trademarks of their respective holders. Unless otherwise indicated, “we,” “us,” “our” and similar terms refer to Arotech and its subsidiaries.

### **EXPLANATORY NOTE**

Arotech Corporation is filing this Amendment No. 1 to its Annual Report on Form 10-K for the year ended December 31, 2007, as filed with the Securities and Exchange Commission on April 14, 2008, in order to correct certain typographical errors in the report. Additionally, as required by SEC regulations, we are replacing the Section 302 and Section 906 certifications from Arotech’s Chairman and Chief Executive Officer and Arotech’s Vice President – Finance and Chief Financial Officer.

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## PART I

### ITEM 7. 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 "Risk Factors," above, and in our other filings with the Securities and Exchange Commission.*

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

#### General

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

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

#### Critical Accounting Policies

The preparation of financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates and judgments, including those related to revenue recognition, allowance for bad debts, 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.

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## ***Revenue Recognition***

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

A portion of our revenue is derived from license agreements that entail the customization of FAAC's simulators to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with Statement of Position 81-1 "Accounting for Performance of Construction – Type and Certain Production – Type Contracts" based on the percentage of completion method over the period from signing of the license through to customer acceptance, as such simulators require significant modification or customization that takes time to complete. The percentage of completion is measured by monitoring progress using records of actual time incurred to date in the project compared with the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

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

We account for our other revenues from IES simulators in accordance with the provisions of SOP 97-2, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants and as amended by SOP 98-4 and SOP 98-9 and related interpretations. We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

We assess whether collection is probable at the time of the transaction based on a number of factors, including the customer's past transaction history and credit worthiness. If we determine that the collection of the fee is not probable, we defer the fee and recognize revenue at the time 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 Financial Accounting Standards Board (“FASB”) Statement No. 123(R) (“SFAS No. 123(R)”), “Share-Based Payment,” using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

### ***Allowance for Doubtful Accounts***

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

### ***Accounting for Income Taxes***

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

We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under Statement of Financial Accounting Standards No. 109, “Accounting for Income Taxes” (“Statement 109”), involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. We do not provide for U.S. federal income taxes on the undistributed earnings of our foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

On January 1, 2007, we adopted the provisions of the Financial Accounting Standards Board Interpretation No.48, Accounting for Uncertainty in Income Taxes (“FIN 48”), an interpretation of Statement 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. We must determine whether it is “more-likely-than-not” that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. FIN 48 applies to all tax positions related to income taxes subject to Statement 109. Uncertain tax positions require determinations and estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If our determinations and estimates prove to be inaccurate, the resulting adjustments could be material to its future financial results. Based on the analysis performed, we did not record any unrecognized tax positions as of December 31, 2007.

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 2007, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

### ***Goodwill***

Under Financial Accounting Standards Board Statement No. 142, “Goodwill and Other Intangible Assets” (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS 142.

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. 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.

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

## **Recent Developments**

### ***Purchase of the Minority Interest in MDT Israel and MDT Armor***

In January 2008, we purchased the minority shareholder's 24.5% interest in MDT Israel and the 12.0% interest in MDT Armor, as well as settling all outstanding disputes regarding severance payments, in exchange for a total of \$1.0 million. We are currently evaluating the impact of this transaction on our first quarter 2008 financial statements.

### ***Purchase of Realtime Technologies, Inc.***

In February 2008 our FAAC subsidiary acquired Realtime Technologies, Inc. (RTI), a privately-owned corporation headquartered in Royal Oak, Michigan, close to the headquarters of the rest of our Training and Simulation Division, for a total of \$1,350,000 (\$1,250,000 in cash and \$100,000 in stock) with a 2008 earn-out (maximum of \$250,000) based on 2008 net profit. Since its founding in 1998, RTI has specialized in multi-body vehicle dynamics modeling and graphical simulation solutions. RTI offers simulation software applications, consulting services, custom engineering solutions, and software and hardware development.

### ***AoA Arbitration***

In connection with our acquisition of AoA, we had a contingent earnout obligation in an amount equal to the revenues AoA realized from certain specific programs that were identified by us and the seller of AoA ("Seller") as appropriate targets for revenue increases. As of December 31, 2006, we had reduced the \$3.0 million escrow held by the Seller by \$1,520,174 for a putative claim against such escrow in respect of such earn-out obligation.

On March 20, 2007, we filed a Demand for Arbitration with the American Arbitration Association against the Seller. In our demand, we sought the return of \$3.0 million, plus interest, held in escrow by the Seller in connection with his sale of AoA to us in 2004. The Seller asserted counterclaims against us in the arbitration, alleging (i) that he is entitled to keep the \$3.0 million, (ii) that he is entitled to an additional \$3.0 million in post-sale earnouts, and (iii) that he is entitled to \$70,000 in compensation (plus interest and statutory penalties) wrongfully withheld by us when we constructively terminated his employment.

In February 2008, the arbitration panel issued a decision denying the Seller's counterclaims (i) and (ii) above, granting the Seller's counterclaim for \$70,000 in compensation, awarding us the entire \$3.0 million escrow (less the \$70,000 in compensation (with simple interest but

without statutory penalties)), and awarding us \$135,000 in attorneys' fees. The time for the Seller to move to vacate or modify this award has not yet expired.

## **Executive Summary**

### *Overview of Results of Operations*

We incurred significant operating losses for the years ended December 31, 2007 and 2006. 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 2007 and 2006 arose as a result of non-cash charges. These charges were primarily related to our acquisitions, financings and issuances of restricted shares and options to employees. To the extent that we continue certain of these activities during 2008, 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 2007. 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 2007 and 2006 in the amount of \$1.4 million and \$1.9 million, respectively.

#### *Financings and Issuances of Restricted Shares, Options and Warrants*

The non-cash charges that relate to our financings occurred in connection with our issuance of convertible securities with warrants, and in connection with our repricing of certain warrants and grants of new warrants. When we issue convertible securities, we record a discount for a beneficial conversion feature that is amortized ratably over the life of the debenture. When a debenture is converted, however, the entire remaining unamortized beneficial conversion feature expense is immediately recognized in the quarter in which the debenture is converted. Similarly, when we issue warrants in connection with convertible securities, we record debt discount for financial expenses that is amortized ratably over the term of the convertible securities; when the

convertible securities are converted, the entire remaining unamortized debt discount is immediately recognized in the quarter in which the convertible securities are converted.

During 2007 and 2006, we issued restricted shares to certain of our employees. These shares were issued as stock bonuses, and are restricted for a period of up to three years from the date of issuance. Relevant accounting rules provide that the aggregate amount of the difference between the purchase price of the restricted shares (in this case, generally zero) and the market price of the shares on the date of grant is taken as a general and administrative expense, amortized over the life of the period of the restriction.

As a result of the application of the above accounting rules, we incurred non-cash charges related to stock-based compensation in 2007 and 2006 in the amount of \$1,332,000 and \$360,000, respectively.

As a result of options granted to employees and the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payments," we incurred non-cash charges related to stock-based compensation in 2007 and 2006 in the amount of \$86,000 and \$141,000, respectively.

As part of the repricings and exercises of warrants described in Note 13 of the Notes to Consolidated Financial Statements, we issued warrants to purchase up to 298,221 shares of common stock. Since the terms of these warrants provided that the warrants were exercisable subject to our obtaining stockholder approval, in accordance with Emerging Issues Task Force No 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the fair value of the warrants was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date until we obtained stockholder approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the stockholder approval) using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$700,000 has been recorded as finance income.

Under the terms of our convertible notes, which have been paid in full, we had the option in respect of scheduled principal repayments to force conversion of the payment amount at a conversion price based upon the weighted average trading price of our common stock during the 20 trading days prior to the conversion, less a discount of 8%.

On April 7, 2006, we and each holder of our convertible notes agreed that we would force immediate conversion of an aggregate of \$6,148,904 principal amount of the convertible notes into 1,098,019 shares of our common stock. The amount converted eliminated our obligation to make the installment payments under the convertible notes on each of March 31, 2008, January 31, 2008, November 30, 2007 and September 30, 2007 (aggregating a total of \$5,833,333). In addition, as a result of the conversion an additional \$315,570 was applied against part of the installment payment due July 31, 2007. After giving effect to the conversion, \$8,434,430 of principal remained outstanding under the convertible notes.

During the remainder of 2006, we converted \$1,458,333 of principal remaining outstanding under our convertible notes by forcing conversion of this principal amount into 526,444 shares of our common stock. During 2007, we converted the remaining \$6,976,097 of principal remaining outstanding under our convertible notes by forcing conversion of this principal amount into 930,125 shares of our common stock.

Additionally, in an effort to improve our cash situation and our shareholders' equity, we have periodically induced holders of certain of our warrants to exercise their warrants by lowering the exercise price of the warrants in exchange for immediate exercise of such warrants, and by issuing to such investors new warrants. Under such circumstances, we record a deemed dividend in an amount determined based upon the fair value of the new warrants (using the Black-Scholes pricing model). As and to the extent that we engage in similar warrant repricings and issuances in the future, we would incur similar non-cash charges.

During 2007 and 2006, the Company recorded expenses of \$19,000 and \$1.5 million, respectively, attributable to amortization related to warrants issued to the holders of convertible debentures and the beneficial conversion feature. During 2007 and 2006, the Company also recorded expenses of \$280,000 and \$5.4 million, respectively, attributable to financial expenses in connection with convertible debenture principle repayment. Additionally, during 2007 and 2006, the Company recorded expenses of \$44,000 and \$781,000, respectively, attributable to amortization of deferred charges related to convertible debentures issuance that were recorded as a general and administrative expense.

### ***Overview of Operating Performance and Backlog***

Overall, our net loss before minority interest earnings, earnings from an affiliated company and tax expenses for 2007 was \$2.8 million on revenues of \$57.7 million, compared to a net loss of \$15.7 million on revenues of \$43.1 million during 2006. As of December 31, 2007, our overall backlog totaled \$48.7 million.

In our Training and Simulation Division, revenues increased from approximately \$22.0 million in 2006 to \$27.8 million in 2007. As of December 31, 2007, our backlog for our Training and Simulation Division totaled \$21.7 million.

In our Battery and Power Systems Division, revenues increased from approximately \$8.6 million in 2006 to approximately \$11.2 million in 2007. As of December 31, 2007, our backlog for our Battery and Power Systems Division totaled \$12.9 million.

In our Armor Division, revenues increased from approximately \$12.6 million in 2006 to approximately \$18.7 million in 2007. As of December 31, 2007, our backlog for our Armor Division totaled \$14.1 million.

## **Results of Operations**

### ***Preliminary Note***

#### *Summary*

Following is a table summarizing our results of operations for the years ended December 31, 2007 and 2006, after which we present a narrative discussion and analysis:

	<b>Year Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Revenues:</b>		
Training and Simulation Division	\$ 27,760,858	\$ 21,951,337
Armor Division	18,724,107	12,571,779
Battery and Power Systems Division	<u>11,234,596</u>	<u>8,597,623</u>
	\$ 57,719,561	\$ 43,120,739
<b>Cost of revenues:</b>		
Training and Simulation Division	\$ 15,528,023	\$ 14,196,298
Armor Division	15,906,071	12,299,756
Battery and Power Systems Division	<u>8,205,718</u>	<u>5,997,592</u>
	\$ 39,639,812	\$ 32,493,646
<b>Research and development expenses:</b>		
Training and Simulation Division	\$ 629,430	\$ 308,738
Armor Division	115,500	20,546
Battery and Power Systems Division	<u>1,132,233</u>	<u>1,272,170</u>
	\$ 1,877,163	\$ 1,601,454
<b>Sales and marketing expenses:</b>		
Training and Simulation Division	\$ 2,956,995	\$ 2,514,981
Armor Division	634,237	366,923
Battery and Power Systems Division	570,768	656,604
All Other	<u>2,464</u>	<u>175,814</u>
	\$ 4,164,464	\$ 3,714,322
<b>General and administrative expenses:</b>		
Training and Simulation Division	\$ 3,400,013	\$ 2,562,868
Armor Division	1,295,079	1,031,333
Battery and Power Systems Division	1,658,968	994,136
All Other	<u>6,804,237</u>	<u>7,104,479</u>
	\$ 13,158,297	\$ 11,692,816
<b>Other income:</b>		
Training and Simulation Division	\$ 122,934	\$ 361,560
Armor Division	152,206	-
All Other	<u>342,812</u>	<u>-</u>
	\$ 617,952	\$ 361,560
<b>Financial expense (income):</b>		
Training and Simulation Division	\$ 14,610	\$ (129,908)
Armor Division	93,292	54,476
Battery and Power Systems Division	176,834	(50,590)
All Other	<u>621,152</u>	<u>7,645,922</u>
	\$ 905,888	\$ 7,519,900
<b>Tax expenses (credits):</b>		
Training and Simulation Division	\$ 69,930	\$ 49,383
Armor Division	2,639	-
Battery and Power Systems Division	(28,653)	-
All Other	<u>120,000</u>	<u>182,776</u>
	\$ 163,916	\$ 232,159
<b>Amortization of intangible assets:</b>		
Training and Simulation Division	\$ 776,736	\$ 1,049,136
Armor Division	95,907	295,067
Battery and Power Systems Division	<u>509,239</u>	<u>509,239</u>
	\$ 1,381,882	\$ 1,853,442
<b>Impairment of goodwill and other intangible assets:</b>		
Armor Division	-	316,024
	\$ -	\$ 316,024
<b>Gain (loss) from affiliated company:</b>		
Training and Simulation Division	\$ (40,230)	\$ 354,898
	\$ (40,230)	\$ 354,898
<b>Minority interest in loss (profit) of subsidiaries:</b>		
Armor Division	(62,296)	17,407
	\$ (62,296)	\$ 17,407
<b>Net income (loss):</b>		
Training and Simulation Division	\$ 4,467,825	\$ 2,116,299
Armor Division	671,292	(1,794,939)
Battery and Power Systems Division	(990,511)	(964,304)
All Other	<u>(7,205,041)</u>	<u>(14,926,215)</u>
	\$ (3,056,435)	\$ (15,569,159)



### *Fiscal Year 2007 compared to Fiscal Year 2006*

**Revenues.** During 2007, we (through our subsidiaries) recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force training systems and from the provision of maintenance services in connection with such systems.
- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products.
- EFB and Epsilon recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army.
- EFL recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for 2007 totaled \$57.7 million, compared to \$43.1 million in 2006, an increase of \$14.6 million, or 33.9%. This increase was primarily attributable to the following factors:

- Increased revenues from our Training and Simulation Division (\$5.8 million more in 2007 versus 2006).
- Increased revenues from our Battery and Power Systems Division (\$2.6 million more in 2007 versus 2006).
- Increased revenues from our Armor Division (\$6.2 million more in 2007 versus 2006).

In 2007, revenues were \$27.8 million for the Training and Simulation Division (compared to \$22.0 million in 2006, an increase of \$5.8 million, or 26.5%, due primarily to increased sales of military vehicle simulators and use of force simulators); \$11.2 million for the Battery and Power Systems Division (compared to \$8.6 million in 2006, an increase of \$2.6 million, or 30.7%, due primarily to increased sales of our battery products at Epsilon and EFB); and \$18.7 million for the Armor Division (compared to \$12.6 million in 2006, an increase of \$6.2 million, or 48.9%, due primarily to increased revenues from MDT and MDT Armor, mostly in respect of orders for the "David" Armored Vehicle).

**Cost of revenues.** Cost of revenues totaled \$39.6 million during 2007, compared to \$32.5 million in 2006, an increase of \$7.1 million, or 22.0%, due primarily to increased sales in all divisions, particularly in the production of the “David” Armored Vehicle in our Armor Division, which accounted for over \$2.0 million of the increase. Total cost of revenues and cost of revenues as a percentage of revenue also increased in the Battery and Power Systems Division due to several factors, primarily the production of new products.

Cost of revenues for our three divisions during 2007 were \$15.5 million for the Training and Simulation Division (compared to \$14.2 million in 2006, an increase of \$1.3 million, or 9.4%, due primarily to increased revenues); \$8.2 million for the Battery and Power Systems Division (compared to \$6.0 million in 2006, an increase of \$2.1 million, or 36.8%, due primarily to increased revenues); and \$15.9 million for the Armor Division (compared to \$12.3 million in 2006, an increase of \$3.6 million, or 29.3%, due primarily to production of the “David” Armored Vehicle).

**Amortization of intangible assets.** Amortization of intangible assets totaled \$1.4 million in 2007, compared to \$1.9 million in 2006, a decrease of \$472,000, or 25.4%, due primarily to completion of the amortization of certain intangible assets at our FAAC and AoA subsidiaries.

**Research and development expenses.** Research and development expenses for 2007 were \$1.9 million, compared to \$1.6 million during 2006, an increase of \$276,000, or 17.2%, due primarily to an increase in expenses at FAAC for expenses associated with the improvements to our simulator products.

**Selling and marketing expenses.** Selling and marketing expenses for 2007 were \$4.2 million, compared to \$3.7 million 2006, an increase of \$450,000, or 12.1%. This increase was primarily attributable to the overall increase in revenues and their associated sales and marketing expenses in our Training and Simulation Division and Armor Division, partially offset by a reduction in expense in our Battery and Power Systems Division.

**General and administrative expenses.** General and administrative expenses for 2007 were \$13.2 million, compared to \$11.7 million in 2006, an increase of \$1.5 million, or 12.5%. This increase was primarily attributable to additional expenses in all three operating divisions, partially offset by a reduction in corporate expenses.

**Financial expenses, net.** Financial expenses totaled approximately \$900,000 in 2007 compared to \$7.5 million in 2006, a decrease of \$6.6 million, or 88.0%. The difference was due primarily to decreased interest related to our convertible notes that were issued in September 30, 2006 as a result of payments of principal during 2006, and financial expenses in 2006 related to repayment by forced conversion of our convertible notes at an 8% discount to average market price as provided under the terms of the convertible notes that did not occur to the same extent in 2007.

**Income taxes.** We and certain of our subsidiaries incurred net operating losses during 2007 and, accordingly, no provision for income taxes was recorded for these losses. With respect to some of our subsidiaries that operated at a net profit during 2007, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of \$164,000 in tax expenses in 2007, compared to \$232,000 in tax expenses in 2006, mainly due to state taxes. We also set up a tax liability for the impact of the deductions taken for good will amounted to \$120,000 in 2007. We also adjusted the 2006 accumulated deficit in the amount of \$900,000 to correct the balances in prior years.



**Impairment of goodwill and other intangible assets.** Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units. We performed the required annual impairment test of goodwill, based on our management's projections and using expected future discounted operating cash flows. We did not identify any impairment of goodwill during 2007. In the corresponding period of 2006, we identified in AoA an impairment of goodwill in the amount of \$316,000.

**Net loss.** Due to the factors cited above, net loss from operations decreased from \$15.6 million in 2006 to \$3.1 million in 2007, an improvement of \$12.7 million, or 81.1%. (Net loss attributable to common stockholders was \$16.0 million in 2006, due to a deemed dividend that was recorded in the amount of \$434,000 in 2006 due to the repricing of existing warrants and the issuance of new warrants.)

### **Liquidity and Capital Resources**

As of December 31, 2007, we had \$3.4 million in cash, \$320,000 in restricted collateral securities, \$1.5 million in an escrow receivable and \$47,000 in available-for-sale marketable securities, as compared to at December 31, 2006, when we had \$2.4 million in cash, \$649,000 in restricted collateral securities, \$1.4 million in an escrow receivable and \$41,000 in available-for-sale marketable securities. We also had \$2.9 million available in unused bank lines of credit, including funds drawn under a \$7.5 million line of credit in favor of our FAAC subsidiary, which line of credit is secured by our assets and the assets of our other subsidiaries and guaranteed by us and our other subsidiaries.

We used available funds in 2007 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets (including the purchase of two buildings in Alabama) by \$2.8 million during the year ended December 31, 2007. Our net fixed assets amounted to \$5.1 million as at year end.

Net cash provided by (used in) operating activities for 2007 and 2006 was \$1.4 million and \$(3.6) million, respectively, an increase of \$5.0 million, due primarily to the reduction of our net loss in 2007, offset in part by an increase in our accounts receivable.

Net cash used in investing activities for 2007 and 2006 was \$1.6 million and \$487,000, respectively. This increase was primarily the result of the purchase of fixed assets along with the payment of promissory notes in respect of an arbitration settlement related to the acquisition of FAAC.

Net cash provided by financing activities for 2007 and 2006 was \$1.1 million and \$452,000, respectively, an increase of \$650,000. This increase was primarily due to the changes in the debenture-related activity.

As of December 31, 2007, we had (based on the contractual amount of the debt and not on the accounting valuation of the debt, not taking into consideration trade payables, other accounts payables and accrued severance pay) approximately \$4.6 million in bank debt outstanding.

Subject to all of the reservations regarding “forward-looking statements” set forth above, we believe that our present cash position, anticipated cash flows from operations and lines of credit should be sufficient to satisfy our current estimated cash requirements through the remainder of the year. In this connection, we note that from time to time our working capital needs are partially dependent on our subsidiaries’ lines of credit. In the event that we are unable to continue to make use of our subsidiaries’ lines of credit for working capital on economically feasible terms, our business, operating results and financial condition could be adversely affected.

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

#### **Effective Corporate Tax Rate**

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2007 and 2006, and accordingly no provision for income taxes was required. With respect to some of our U.S. subsidiaries that operated at a net profit during 2007, we were able to offset federal taxes against our net operating loss carryforward, which amounted to approximately \$7.2 million as of December 31, 2007. 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 2007, 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 29% in 2007 (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, 2007, we had a U.S. net operating loss carryforward of approximately \$7.2 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2009 through 2026, and foreign net operating and capital loss carryforwards of approximately \$106 million, which are available indefinitely to offset future taxable income under certain circumstances.

#### **Contractual Obligations**

The following table lists our contractual obligations and commitments as of December 31, 2007, not including trade payables and other accounts payable:

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt	\$ 1,192,342	\$ 103,844	\$ 72,182	\$ 66,215	\$ 950,101
Short-term debt*	\$ 4,557,890	\$ 4,557,890	\$ –	\$ –	\$ –
Promissory note due to purchase of subsidiaries	\$ 151,450	\$ 151,450	\$ –	\$ –	\$ –
Operating lease obligations**	\$ 4,302,191	\$ 637,760	\$ 997,535	\$ 1,021,224	\$ 1,645,672
Capital lease obligations	\$ 154,532	\$ 67,543	\$ 72,411	\$ 14,578	\$ –
Severance obligations***	\$ 4,853,231	\$ –	\$ 4,853,231	\$ –	\$ –

\* Primarily in short-term bank debt.

\*\* Includes operating lease obligations related to rent.

\*\*\* Includes obligations related to special severance pay arrangements in addition to the severance amounts due to certain employees pursuant to Israeli severance pay law (the amount shown in the table above with payment due during the next 1-3 years might not be paid in the period stated in the event the employment agreements to which such severance obligations relate are extended).

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

### Index to Financial Statements

	<u>Page</u>
<b><u>Consolidated Financial Statements</u></b>	
Report of Independent Registered Public Accounting Firm	F-1
Consolidated Balance Sheets	F-2
Consolidated Statements of Operations	F-4
Statements of Changes in Stockholders' Equity	F-5
Consolidated Statements of Cash Flows	F-7
Notes to Consolidated Financial Statements	F-9
<b><u>Financial Statement Schedule</u></b>	
Schedule II – Valuation and Qualifying Accounts	F-45

*The financial statements have been restated to give effect to a one-for-fourteen reverse stock split effected on June 21, 2006.*

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

- (a) The following documents are filed as part of this report:
- (1) Financial Statements – See Index to Financial Statements on page 15 above and the financial pages following page 19 below.
  - (2) Financial Statements Schedules – Schedule II - Valuation and Qualifying Accounts. All schedules other than those listed above are omitted because of the absence of conditions under which they are required or because the required information is presented in the financial statements or related notes thereto.
  - (3) Exhibits – The following Exhibits are either filed herewith or have previously been filed with the Securities and Exchange Commission and are referred to and incorporated herein by reference to such filings:

<u>Exhibit No.</u>	<u>Description</u>
(1) 3.1	Amended and Restated Certificate of Incorporation
(3) 3.1.1	Amendment to our Amended and Restated Certificate of Incorporation
(8) 3.1.2	Amendment to our Amended and Restated Certificate of Incorporation
(9) 3.1.3	Amendment to our Amended and Restated Certificate of Incorporation
(18) 3.1.4	Amendment to our Amended and Restated Certificate of Incorporation
(2) 3.2	Amended and Restated By-Laws
(9) 4.1	Specimen Certificate for shares of common stock, \$.01 par value
(14) 10.1	Promissory Note dated December 3, 1999, from Robert S. Ehrlich to us
(14) 10.2	Promissory Note dated February 9, 2000, from Robert S. Ehrlich to us
(14) 10.3	Promissory Note dated January 12, 2001, from Robert S. Ehrlich to us
(4) 10.4	Agreement of Lease dated December 6, 2000 between Janet Nissim <i>et al.</i> and M.D.T. Protection (2000) Ltd. [English summary of Hebrew original]
(4) 10.5	Agreement of Lease dated August 22, 2001 between Aviod Building and Earthworks Company Ltd. <i>et al.</i> and M.D.T. Protective Industries Ltd. [English summary of Hebrew original]
(5) 10.6	Form of Warrant dated September 30, 2003
(6) 10.7	Form of Warrant dated January __, 2004
(7) 10.8	Promissory Note dated July 1, 2002 from Robert S. Ehrlich to us
(7) 10.9	Lease dated April 8, 1997, between AMR Holdings, L.L.C. and FAAC Incorporated
†(9) 10.10	Consulting Agreement, effective as of January 1, 2005, between us and Sampen Corporation
†(19) 10.11	Fourth Amended and Restated Employment Agreement, dated April 16, 2007, between us, EFL and Robert S. Ehrlich
†(10) 10.12	Employment Agreement, effective as of January 1, 2005, between EFL and Steven Esses

<u>Exhibit</u>	<u>Description</u>
<u>No.</u>	
†(21) 10.12.1	Amended and Restated Employment Agreement, dated April 14, 2008 and effective as of January 1, 2008, between EFL and Steven Esses
(16) 10.13	Conversion Agreement dated April 7, 2006 between us and the Investors named therein
(11) 10.14	Form of Warrant dated September 29, 2005
†(12) 10.15	Employment Agreement between the Company and Thomas J. Paup dated December 30, 2005
†(21) 10.15.1	Amended and Restated Employment Agreement between the Company and Thomas J. Paup dated April 14, 2008 and effective as of January 1, 2008
†(12) 10.16	Separation Agreement and Release of Claims among the Company, EFL and Avihai Shen dated January 5, 2006
(13) 10.17	Form of Warrant dated February 15, 2006
(14) 10.18	Lease dated February 10, 2006 between Arbor Development Company LLC and FAAC Incorporated
(15) 10.19	Form of Warrant dated March 27, 2006
(17) 10.20	Form of Warrant dated April 11, 2006
(20) 10.21	Loan Agreement between FAAC Incorporated and Keybank National Association dated December 27, 2007
(20) 10.22	Security Agreement between us and Keybank National Association dated December 27, 2007
(20) 10.23	Guaranty from us to Keybank National Association dated December 27, 2007
*(21) 10.24	Agreement with Yossi Bar in respect of our purchase of the minority interest of M.D.T. Protective Industries Ltd. and MDT Armor Corporation dated January 15, 2008
*(21) 10.25	Stock Purchase Agreement among FAAC Incorporated, Realtime Technologies Ltd. and Richard Romano dated February 4, 2008
(9) 21.1	List of Subsidiaries of the Registrant
** 23.1	Consent of BDO Seidman, LLP
** 31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
** 31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
** 32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
** 32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* English translation or summary from original Hebrew

\*\* Filed herewith

† Includes management contracts and compensation plans and arrangements

(1) Incorporated by reference to our Registration Statement on Form S-1 (Registration No. 33-73256), which became effective on February 23, 1994

(2) Incorporated by reference to our Registration Statement on Form S-1 (Registration No. 33-97944), which became effective on February 5, 1996

- (3) Incorporated by reference to our Current Report on Form 8-K filed January 6, 2003
- (4) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2002
- (5) Incorporated by reference to our Current Report on Form 8-K filed October 3, 2003
- (6) Incorporated by reference to our Current Report on Form 8-K filed January 9, 2004
- (7) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2003
- (8) Incorporated by reference to our Current Report on Form 8-K filed July 15, 2004
- (9) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2004
- (10) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004
- (11) Incorporated by reference to our Current Report on Form 8-K filed September 30, 2005
- (12) Incorporated by reference to our Current Report on Form 8-K filed January 5, 2006
- (13) Incorporated by reference to our Current Report on Form 8-K filed February 16, 2006
- (14) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2005
- (15) Incorporated by reference to our Current Report on Form 8-K filed March 30, 2006
- (16) Incorporated by reference to our Current Report on Form 8-K filed April 7, 2006
- (17) Incorporated by reference to our Current Report on Form 8-K filed April 12, 2006
- (18) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006
- (19) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2006
- (20) Incorporated by reference to our Current Report on Form 8-K filed January 3, 2008
- (21) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2007

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this amended report to be signed on its behalf by the undersigned, thereunto duly authorized, on April 28, 2008.

### AROTECH CORPORATION

By: /s/ Robert S. Ehrlich

Name: Robert S. Ehrlich

Title: Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this amended report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Robert S. Ehrlich</u> Robert S. Ehrlich	Chairman Chief Executive Officer and Director (Principal Executive Officer)	April 28, 2008
<u>/s/ Thomas J. Paup</u> Thomas J. Paup	Vice President – Finance (Principal Financial Officer)	April 28, 2008
<u>/s/ Norman Johnson</u> Norman Johnson	Controller (Principal Accounting Officer)	April 28, 2008
<u>/s/ Steven Esses</u> Steven Esses	President, Chief Operating Officer and Director	April 28, 2008
<u>Dr. Jay M. Eastman</u>	Director	April __, 2008
<u>/s/ Lawrence M. Miller</u> Lawrence M. Miller	Director	April 28, 2008
<u>/s/ Jack E. Rosenfeld</u> Jack E. Rosenfeld	Director	April 28, 2008
<u>Edward J. Borey</u>	Director	April __, 2008
<u>Seymour Jones</u>	Director	April __, 2008
<u>Elliot Sloyer</u>	Director	April __, 2008
<u>/s/ Michael E. Marrus</u> Michael E. Marrus	Director	April 28, 2008

## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Arotech Corporation:

We have audited the accompanying consolidated balance sheets of Arotech Corporation and subsidiaries as of December 31, 2007 and 2006 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 schedules 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 as of December 31, 2007 and 2006, and the results of their operations and their 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.

Grand Rapids, Michigan  
April 14, 2008

/s/ BDO Seidman, LLP  
BDO Seidman, LLP

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**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

In U.S. dollars

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 3,447,671	\$ 2,368,872
Restricted collateral deposits	320,454	648,975
Escrow receivable	1,479,826	1,479,826
Available for sale marketable securities	47,005	41,166
Trade receivables (net of allowance for doubtful accounts in the amounts of \$25,000 and \$159,000 as of December 31, 2007 and 2006, respectively)	14,583,213	7,780,965
Unbilled receivables	3,271,594	6,902,533
Other accounts receivable and prepaid expenses	1,614,614	1,134,622
Inventories	7,887,820	7,851,820
Total current assets	<u>32,652,197</u>	<u>28,208,779</u>
SEVERANCE PAY FUND	2,815,040	2,246,457
OTHER LONG-TERM RECEIVABLES	386,899	262,608
PROPERTY AND EQUIPMENT, NET	5,079,796	3,740,593
INVESTMENT IN AFFILIATED COMPANY	352,168	392,398
OTHER INTANGIBLE ASSETS, NET	7,837,076	9,502,214
GOODWILL	<u>31,358,131</u>	<u>30,715,225</u>
Total long term assets	<u>47,829,110</u>	<u>46,859,495</u>
	<u>\$ 80,481,307</u>	<u>\$ 75,068,274</u>

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

In U.S. dollars

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables	\$ 4,233,288	\$ 2,808,131
Other accounts payable and accrued expenses	4,889,729	5,171,055
Current portion of capitalized leases	67,543	55,263
Current portion of promissory notes due to purchase of subsidiaries	151,450	302,900
Current portion of long term debt	103,844	–
Short term bank credit	4,557,890	3,496,008
Deferred revenues	2,903,166	1,321,311
Convertible debenture	–	2,583,629
<b>Total current liabilities</b>	<b>16,906,910</b>	<b>15,738,297</b>
<b>LONG TERM LIABILITIES</b>		
Accrued severance pay	4,853,231	4,039,049
Long term portion of promissory notes due to purchase of subsidiaries	–	151,450
Long term portion of capitalized leases	86,989	158,120
Long term portion of long term debt	1,088,498	–
Other long term liabilities	110,255	–
Deferred Taxes	1,020,000	900,000
<b>Total long-term liabilities</b>	<b>7,158,973</b>	<b>5,248,619</b>
<b>MINORITY INTEREST</b>	<b>83,816</b>	<b>21,520</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Share capital –		
Common stock – \$0.01 par value each;		
Authorized: 250,000,000 shares as of December 31, 2007 and 2006; Issued: 13,544,819 shares and 12,023,242 shares as of December 31, 2007 and 2006, respectively; Outstanding – 13,544,819 shares and 11,983,575 shares as of December 31, 2007 and 2006, respectively	135,448	120,232
Preferred shares – \$0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2007 and 2006; No shares issued and outstanding as of December 31, 2007 and 2006	–	–
Additional paid-in capital	218,551,110	217,735,860
Accumulated deficit	(162,522,558)	(159,466,123)
Treasury stock, at cost (common stock – none as of December 31, 2007 and 39,667 shares as of December 31, 2006)	–	(3,537,106)
Notes receivable from shareholders	(1,333,833)	(1,304,179)
Accumulated other comprehensive income	1,501,441	511,154
<b>Total stockholders' equity</b>	<b>56,331,608</b>	<b>54,059,838</b>
	<b>\$ 80,481,307</b>	<b>\$ 75,068,274</b>

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**

	<u>2007</u>	<u>2006</u>
Revenues	\$ 57,719,561	\$ 43,120,739
Cost of revenues, exclusive of amortization of intangibles	39,639,812	32,493,646
Research and development	1,877,163	1,601,454
Selling and marketing expenses	4,164,464	3,714,322
General and administrative expenses	13,158,297	11,692,816
Amortization of intangible assets	1,381,882	1,853,442
Impairment of goodwill and other intangible assets	—	316,024
Total operating costs and expenses	<u>60,221,618</u>	<u>51,671,704</u>
Operating loss	(2,502,057)	(8,550,965)
Other income	617,952	361,560
Financial expenses, net	<u>(905,888)</u>	<u>(7,519,900)</u>
Loss before minority interest in earnings of a subsidiaries, earnings from affiliated company, and income tax expenses	(2,789,993)	(15,709,305)
Income taxes	(163,916)	(232,159)
Gain (loss) from affiliated company	(40,230)	354,898
Minority interest in loss (earnings) of subsidiaries	<u>(62,296)</u>	<u>17,407</u>
Net loss	\$ (3,056,435)	\$ (15,569,159)
Deemed dividend to certain stockholders	<u>\$ —</u>	<u>\$ (434,185)</u>
Net loss attributable to common stockholders	<u>\$ (3,056,435)</u>	<u>\$ (16,003,344)</u>
Basic and diluted net loss per share	<u>\$ (0.27)</u>	<u>\$ (1.87)</u>
Weighted average number of shares used in computing basic and diluted net loss per share	<u>11,274,387</u>	<u>8,569,191</u>

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	Deferred stock compensation	Treasury stock	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
	Shares	Amount								
Balance as of January 1, 2006, as previously reported	6,221,194	\$ 870,969	\$193,949,882	\$(142,996,964)	\$ (389,303)	\$(3,537,106)	\$ (1,256,777)	\$ (375,445)	\$ -	\$ 46,265,256
Prior Period Adjustment	-	-	-	(900,000)	-	-	-	-	-	(900,000)
Balance of January 1, 2006, as adjusted	6,221,194	\$ 870,969	\$193,949,882	\$(143,896,964)	\$ (389,303)	\$(3,537,106)	\$ (1,256,777)	\$ (375,445)	\$ -	\$ 45,365,256
Adjustment of fractional shares due to reverse split	(142)	(808,757)	808,757	-	-	-	-	-	-	-
FAS 123R reclassification	-	-	(389,303)	-	389,303	-	-	-	-	-
Principal installment of convertible debenture payment in shares	4,184,855	41,848	18,477,301	-	-	-	-	-	-	18,519,149
Warrants exercise	745,549	7,455	4,343,180	-	-	-	-	-	-	4,350,635
Stock based compensation	-	-	500,545	-	-	-	-	-	-	500,545
Stock options and restricted stock	871,786	8,717	(1,904)	-	-	-	-	-	-	6,813
Interest accrued on notes receivable from shareholders	-	-	47,402	-	-	-	(47,402)	-	-	-
Other comprehensive loss - foreign currency translation adjustment	-	-	-	-	-	-	-	885,733	885,733	885,733
Other comprehensive loss - unrealized gain on available for sale marketable securities	-	-	-	-	-	-	-	866	866	866
Net loss	-	-	-	(15,569,159)	-	-	-	-	(15,569,159)	(15,569,159)
Total comprehensive loss	-	-	-	-	-	-	-	-	(14,682,560)	-
Balance as of December 31, 2006	<u>12,023,242</u>	<u>\$ 120,232</u>	<u>\$217,735,860</u>	<u>\$(159,466,123)</u>	<u>\$ 0</u>	<u>\$(3,537,106)</u>	<u>\$ (1,304,179)</u>	<u>\$ 511,154</u>	<u>\$ -</u>	<u>\$ 54,059,838</u>

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	Treasury stock	Notes receivable from stockholders	Accumulated	Total	Total stockholders' equity
	Shares	Amount					other comprehensive income (loss)	comprehensive income (loss)	
Balance as of									
January 1, 2007	12,023,242	\$ 120,232	\$ 217,735,860	\$ (159,466,123)	\$ (3,537,106)	\$ (1,304,179)	\$ 511,154	\$ -	\$ 54,059,838
Principal installment of convertible debenture payment in shares	930,125	9,301	2,873,454	-	-	-	-	-	2,882,755
Treasury shares cancellation	(39,666)	(396)	(3,536,710)	-	3,537,106	-	-	-	-
Stock based compensation	-	-	1,417,521	-	-	-	-	-	1,417,521
Stock options and restricted stock	631,118	6,311	31,331	-	-	-	-	-	37,642
Interest accrued on notes receivable from shareholders	-	-	29,654	-	-	(29,654)	-	-	-
Other comprehensive loss – foreign currency translation adjustment	-	-	-	-	-	-	988,740	988,740	988,740
Other comprehensive loss – unrealized gain on available for sale marketable securities	-	-	-	-	-	-	1,547	1,547	1,547
Net loss	-	-	-	(3,056,435)	-	-	-	(3,056,435)	(3,056,435)
Total comprehensive loss	-	-	-	-	-	-	-	(2,066,148)	-
Balance as of									
December 31, 2007	<u>13,544,819</u>	<u>\$ 135,448</u>	<u>\$ 218,551,110</u>	<u>\$ (162,522,558)</u>	<u>\$ 0</u>	<u>\$ (1,333,833)</u>	<u>\$ 1,501,441</u>		<u>\$ 56,331,608</u>

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**In U.S. dollars**

	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:		
Net loss	\$ (3,056,435)	\$ (15,569,159)
Adjustments required to reconcile net loss to net cash used in operating activities:		
Minorities interests in loss (earnings) of subsidiary	62,296	(17,407)
Loss (gain) from affiliated company	40,230	(354,898)
Depreciation	1,376,749	1,966,748
Amortization of intangible assets, capitalized software costs and impairment of intangible assets	1,953,164	2,857,891
Remeasurement of liability in connection to warrants granted	-	(700,113)
Accrued severance pay, net	245,599	194,810
Compensation related to shares issued to employees, consultants and directors	1,417,521	507,081
Impairment of property and equipment	-	32,485
Financial expenses in connection with convertible debenture principle repayment	280,382	5,395,338
Amortization related to warrants issued to the holders of convertible debentures and beneficial conversion feature	18,745	1,485,015
Amortization of deferred charges related to convertible debentures issuance	44,253	780,719
Capital loss (gain) from sale of property and equipment	56,224	(1,842)
Decrease (increase) in trade receivables	(6,802,248)	3,631,978
Decrease (increase) in other accounts receivable and prepaid expenses	(706,569)	605,610
Decrease in deferred taxes	100,323	6,788
Decrease (increase) in inventories	(36,000)	83,926
Increase (decrease) in unbilled revenues	3,630,939	(1,674,029)
Increase in deferred revenues	1,581,854	718,290
Increase (decrease) in trade payables	1,425,156	(3,156,665)
Decrease in other accounts payable and accrued expenses	(137,834)	(296,866)
Net cash provided by (used in) operating activities from continuing operations	1,494,349	(3,504,300)
Net cash used in operating activities from discontinued operations	-	(120,000)
Net cash provided by (used in) operating activities	\$ 1,494,349	\$ (3,624,300)
Cash flows from investing activities:		
Purchase of property and equipment	(1,594,426)	(1,412,383)
Increase in capitalized software costs	(15,750)	(688,443)
Payment of additional required payout for FAAC acquisition	-	(630,350)
Repayment of promissory notes related to acquisition of subsidiaries	(302,900)	-
Proceeds from sale of property and equipment	36,061	-
Increase in escrow receivable	-	(1,479,826)
Decrease in restricted cash	322,682	3,723,611
Net cash used in investing activities	\$ (1,554,333)	\$ (487,391)

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**

	<b>2007</b>	<b>2006</b>
Forward	(59,985)	(4,111,691)
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of options	37,642	250
Proceeds from exercise of warrants	–	4,350,635
Repayment of convertible debentures	–	(5,204,167)
Repayment of long term loan	(21,468)	(149,414)
Increase in short term bank credit	1,061,883	1,455,309
Net cash provided by financing activities	<u>1,078,057</u>	<u>452,613</u>
Increase (decrease) in cash and cash equivalents	1,018,073	(3,659,078)
Cash accretion (erosion) due to exchange rate differences	60,726	(122,702)
Cash and cash equivalents at the beginning of the year	<u>2,368,872</u>	<u>6,150,652</u>
Cash and cash equivalents at the end of the year	<u>\$ 3,447,671</u>	<u>\$ 2,368,872</u>
<b>Supplementary information on non-cash transactions:</b>		
Payment of principle installment of convertible debenture in shares	\$ 2,882,753	\$ 18,519,149
Mortgage note payable (seller financed) issued for purchase of building	\$ 1,115,000	\$ –
Interest paid during the period	\$ 662,789	\$ 2,018,061

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 1:- GENERAL**

a. Corporate structure:

Arotech Corporation (“Arotech” or the “Company”) and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced high-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles, and in the design, development and commercialization of its proprietary zinc-air battery technology for electric vehicles and defense applications. The Company is primarily operating through FAAC Corporation, a wholly-owned subsidiary based in Ann Arbor, Michigan; Electric Fuel Battery Corporation, a wholly-owned subsidiary based in Auburn, Alabama; Electric Fuel Ltd. (“EFL”) a wholly-owned subsidiary based in Beit Shemesh, Israel; Epsilon Electronic Industries, Ltd., a wholly-owned subsidiary located in Dimona, Israel; M.D.T. Protective Industries, Ltd. (“MDT”), a majority-owned (now wholly-owned; see Note 18.b.) subsidiary based in Lod, Israel; MDT Armor Corporation, a majority-owned (now wholly-owned; see Note 18.b.) subsidiary based in Auburn, Alabama; and Armour of America, Incorporated, a wholly-owned subsidiary based in Auburn, Alabama.

Revenues derived from the Company’s largest customers in 2007 and 2006 are described in Note 16.d.

b. Acquisition of FAAC:

The Company had a contingent earnout obligation in an amount equal to the net income realized by the Company from certain specific programs that were identified by the Company and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. During 2005 and 2006, the Company accrued an amount of \$603,764 and \$630,000, respectively, in respect of such earnout obligation to increase FAAC’s goodwill. The \$151,450 shown as promissory notes in the balance sheet is the portion of the 2006 earnout that is paid in equal installments that started in January 2007 and will be paid in full in June 2008. The promissory note is non-interest bearing.

c. Acquisition of AoA:

The total purchase price consisted of \$19,000,000 in cash, with additional possible earn-outs if AoA was awarded certain material contracts. An additional \$3,000,000 was to be paid into an escrow account pursuant to the terms of an escrow agreement, to secure a portion of the Earnout Consideration. These funds are currently being held by the seller of AoA. As of December 31, 2007, the Company had reduced the \$3.0 million escrow held by the seller of AoA by \$1,520,174 for a putative claim against such escrow in respect of such earn-out obligation. When the contingency on the earn-out provision is resolved, the additional consideration, if any, will be recorded as additional purchase price. Any recovery of the previously expensed escrow amount will be recorded as income in the period received.

In March 2007, the Company filed a Demand for Arbitration with the American Arbitration Association against the seller of AoA. The Company sought the return of the \$3.0 million escrow, plus interest. The seller of AoA asserted counterclaims against the Company in the arbitration, alleging (i) that he is entitled to keep the \$3.0 million, (ii) that he is entitled to an additional \$3.0 million in



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 1:- GENERAL (Cont.)**

post-sale earnouts, and (iii) that he is entitled to \$70,000 in compensation (plus interest and statutory penalties) wrongfully withheld by the Company when it constructively terminated his employment.

In December 2007, the matter was brought before an arbitration panel and in February 2008, the arbitration panel issued a decision, granting the seller's counterclaim for \$70,000 in compensation, awarding the Company the entire \$3.0 million escrow (less the \$70,000 in compensation (with simple interest but without statutory penalties)), and awarding the Company \$135,000 in attorneys' fees. The federal district court for the Southern District of New York has not yet ruled upon the Company's petition to confirm the arbitration award.

d. Impairment of goodwill and other intangible assets:

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

In 2007, the Company evaluated all goodwill and it was determined that there was no impairment.

In 2006, the Company identified an additional \$316,024 in potential earn-out obligations in an amount equal to the revenues realized by the Company from certain specific programs at AoA. This expense is shown as impairment expense since the full amount of AoA goodwill had been previously written off in 2005.

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

e. Reverse stock split:

On June 20, 2006, the Company filed a Certificate of Amendment with the Delaware Secretary of State which served to effect, as of 7:00 a.m. e.d.t. on June 21, 2006, a one-for-fourteen reverse split of the Company's common stock. As a result of the reverse stock split, every fourteen shares of the Company's common stock were combined into one share of common stock; any fractional shares created by the reverse stock split were eliminated. The par value of the shares remained unchanged. The reverse stock split affected all of the Company's common stock, stock options, warrants

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 1:- GENERAL (Cont.)**

and convertible debt outstanding immediately prior to the effective date of the reverse stock split. The reverse split reduced the number of shares of the Company's common stock outstanding at June 21, 2006 from 118,587,361 shares to 8,468,957 shares. All references to common share and per common share amounts for all periods presented have been retroactively restated to reflect this reverse split.

f. Related parties

The Company has a consulting agreement with Sampen Corporation that it executed in March 2005, effective as of January 1, 2005. Sampen is a New York corporation owned by members of the immediate family of one of the Company's executive officers, and this executive officer is an employee of both the Company and of Sampen. The term of this consulting agreement as extended expires on December 31, 2008, and is extended automatically for additional terms of two years each unless either Sampen or the Company terminate the agreement sooner.

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

During the years ended December 31, 2007 and 2006 the Company paid Sampen a total of \$219,354 and \$208,896, 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, 2007, the aggregate amount outstanding pursuant to this promissory note was \$201,570.

On February 9, 2000, Mr. Ehrlich exercised 9,404 stock options. Mr. Ehrlich paid the exercise price of the stock options and certain taxes that the Company paid on his behalf by giving the Company a non-recourse promissory note due in 2025 in the amount of \$789,991, bearing annual interest (i) as to \$329,163, at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, and (ii) as to \$460,828, at 4% over the then-current percentage increase in the Israeli consumer price index between the date of the loan and the date of the annual interest calculation, secured by the shares of the Company's common stock acquired through the exercise of the options and certain compensation due to Mr. Ehrlich upon termination. As of

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 1:- GENERAL (Cont.)**

December 31, 2007, the aggregate amount outstanding pursuant to this promissory note was \$820,809.

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, 2007, the aggregate amount outstanding pursuant to this promissory note was \$45,388.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

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

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

A majority of the revenues of the Company and most of its subsidiaries and its subsidiaries' affiliates is generated in U.S. dollars. In addition, a substantial portion of the Company's and most of its subsidiaries costs are incurred in U.S. dollars ("dollar"). Management believes that the dollar is the primary currency of the economic environment in which the Company and most of its subsidiaries operate. Thus, the functional and reporting currency of the Company and most of its subsidiaries is the dollar. Accordingly, monetary accounts maintained in currencies other than the U.S. dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transaction, gains and losses from the remeasured monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Restricted collateral deposits

Restricted cash is primarily invested in highly liquid deposits which are used as a security for the Company's guarantee performance, its liability to a former shareholder of its acquired subsidiary and for the company's liability for interest payments related to its convertible debentures.

f. Marketable securities

The Company and its subsidiaries account for investments in debt and equity securities in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

At December 31, 2007 the Company and its subsidiaries classified its investment in marketable securities as available-for-sale.

Investment in trust funds are classified as available-for-sale and stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of income.

g. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence and for market prices lower than cost. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are made to write inventory down to its market value. In 2007 and 2006, the Company wrote off \$150,681 and \$292,864, of obsolete inventory respectively, which has been included in the cost of revenues.

Cost is determined as follows:

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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

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

h. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants received from the State of Israel for investments in fixed assets under the Investment Law (no investment grants were received during 2007 and 2006).

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

	<u>%</u>
Computers and related equipment	33
Motor vehicles	15
Office furniture and equipment	6 - 10
Machinery and equipment	10 - 25 (mainly 10)
Leasehold improvements	By the shorter of the term of the lease or the life of the asset

i. Revenue recognition:

The Company is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. During 2007 and 2006, the Company and its subsidiaries recognized revenues as follows: (i) from the sale and customization of interactive training systems and from the maintenance services in connection with such systems (Training and Simulation Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery and Power Systems Division); and (iv) from the sale of lifejacket lights (Battery and Power Systems Division).

Revenues from the Battery and Power Systems Division products and Armor Division are recognized in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probable, and no further obligation remains.

Revenues from contracts that involve customization of FAAC's simulation system to customer specific specifications are recognized in accordance with Statement Of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," using contract accounting on a percentage of completion method, in accordance with the "Input Method." The amount of revenue recognized is based on the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual time incurred

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

to date in the project compared to the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. During 2006 \$741,165 in estimated losses were identified and expensed.

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

Revenues from simulators, which do not require significant customization, are recognized in accordance with Statement of Position 97-2, "Software Revenue Recognition," ("SOP 97-2"). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has adopted Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions" ("SOP 98-9"). According to SOP No. 98-9, revenues are allocated to the different elements in the arrangement under the "residual method" when Vendor Specific Objective Evidence ("VSOE") of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the residual method, at the outset of the arrangement with the customer, the Company defers revenue for the fair value of its undelivered elements (maintenance and support) and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (software product) when all other criteria in SOP 97-2 have been met.

Revenue from such simulators is recognized when persuasive evidence of an agreement exists, delivery has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectibility is probable.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support services. Revenues from training are recognized when it is performed. The VSOE of fair value of the maintenance, training and support services is determined based on the price charged when sold separately or when renewed.

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

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

j. Right of return:

When a right of return exists, the Company defers its revenues until the expiration of the period in which returns are permitted.

k. Warranty:

The Company offers up to one year warranty for most of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the Company does business. The Company estimates the costs that may be incurred under its basic limited warranty, including parts and labor. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs as the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. See Note 18.

l. Research and development cost:

SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires capitalization of certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred, when applicable. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release, have been capitalized. Capitalized software costs will be amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software bears to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (two to five years). The Company assesses the net realizable value of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2007.

m. Income taxes:

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

n. Concentrations of credit risk:

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

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

The Company's available for sale marketable securities include investments in debentures of U.S. and Israeli corporations and state and local governments. Management believes that those corporations and states are institutions that are financially sound, that the portfolio is well diversified, and accordingly, that minimal credit risk exists with respect to these marketable securities.

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

o. Basic and diluted net loss per share:

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

All outstanding stock options, non vested restricted stock and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share was 1,791,562 and 1,781,984, for the years ended December 31, 2007 and 2006, respectively.

p. Accounting for stock-based compensation

Effective January 1, 2006, the Company started to account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R) ("SFAS No. 123(R)", "Share-Based Payment," using the modified prospective transition method. Under SFAS No. 123(R), stock-based



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. The Company determines the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values. The adoption of SFAS No. 123(R) resulted in a reduction in income of \$500,445 in 2006, which reduced basic and diluted EPS for the year by \$0.06.

The fair value for the 2006 options granted to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 4.64% (based on three-year U.S. Treasury bonds); a dividend yield of 0.0%, a volatility factor of the expected market price of the common stock of 1.33 (based on historical volatility of the stock over the previous three years); and a weighted-average expected life of the option of three years. The Company did not grant any options in 2007. The Company assumed a 20% forfeiture rate for options for both years. The Company uses a 10% forfeiture rate for restricted stock.

q. Fair value of financial instruments:

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

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

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

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

r. Severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. Israeli employees are entitled to one month's salary for each year of employment, or a portion thereof. The Company's liability for all of its Israeli employees is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

In addition and according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. The Company has made a provision for this special severance pay in accordance with EITF 88-1: "Determination of Vested Benefit Obligation for a Defined Benefit

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Pension Plan” As of December 31, 2007 and 2006, the accumulated severance pay in that regard amounted to \$2,081,587 and \$2,163,264, respectively.

Pursuant to the terms of the employment agreement between the Company and its Chief Executive Officer, funds to secure payment of the Chief Executive Officer’s contractual severance are to be deposited for the benefit of the Chief Executive Officer, with payments to be made pursuant to an agreed-upon schedule. As of December 31, 2007, a total of \$618,097 had been deposited. These funds continue to be owned by the Company, which benefits from all gains and bears the risk of all losses resulting from investments of these funds.

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

Severance expenses for the years ended December 31, 2007 and 2006 amounted to \$334,749 and \$563,302, respectively.

s. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2007 and 2006 was approximately \$92,775 and \$21,000, respectively.

t. New accounting pronouncements:

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*, to further enhance the accounting and financial reporting related to business combinations. SFAS No. 141(R) establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Therefore, the effects of the Corporation’s adoption of SFAS No. 141(R) will depend upon the extent and magnitude of acquisitions after December 31, 2008.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. The Statement does not require any new fair value measurements and was initially effective for the Corporation

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

beginning January 1, 2008. In February 2008, the FASB approved the issuance of FASB Staff Position (FSP) FAS 157-2. FSP FAS 157-2 defers the effective date of SFAS No. 157 until January 1, 2009 for nonfinancial assets and nonfinancial liabilities except those items recognized or disclosed at fair value on an annual or more frequently recurring basis. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement permits entities to choose to measure eligible items at fair value at specified election dates. For items for which the fair value option has been elected, unrealized gains and losses are to be reported in earnings at each subsequent reporting date. The fair value option is irrevocable unless a new election date occurs, may be applied instrument by instrument, with a few exceptions, and applies only to entire instruments and not to portions of instruments. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting. SFAS No. 159 is effective for the Corporation beginning January 1, 2008. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*, to create accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary.

SFAS No. 160 establishes accounting and reporting standards that require (1) the ownership interest in subsidiaries held by parties other than the parent to be clearly identified and presented in the consolidated balance sheet within equity, but separate from the parent's equity, (2) the amount of consolidated net income attributable to the parent and the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of income, (3) changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary to be accounted for consistently, (4) when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary to be initially measured at fair value, and (5) entities to provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 applies to fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, and prohibits early adoption. Management has not completed its review of the new guidance; however, the effect of the Statement's implementation is not expected to be material to the Corporation's results of operations or financial position.

u. **Reclassification:**

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

**NOTE 3:- RESTRICTED COLLATERAL DEPOSITS**

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Short-term:		
Deposits in connection with MDT Israel projects	\$ 254,668	\$ -
Deposits in connection with FAAC projects	-	535,151
Restricted cash in connection with interest payment to convertible debenture holders.		113,824
Deposits in connection with EFL projects	65,786	-
<b>Total Restricted Collateral</b>	<b>\$ 320,454</b>	<b>\$ 648,975</b>

**NOTE 4: - AVAILABLE FOR SALE MARKETABLE SECURITIES**

The following is a summary of investments in marketable securities as of December 31, 2007 and 2006:

	<b>Cost</b>		<b>Unrealized gains</b>		<b>Estimated fair value</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Available for sale marketable securities	\$ 41,166	\$ 36,708	\$ 5,839	\$ 4,458	\$ 47,005	\$ 41,166

**NOTE 5:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES**

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Government authorities	\$ 259,036	\$ 213,362
Employees	60,950	77,836
Prepaid expenses	790,157	292,496
Deferred taxes	-	58,032
Other	504,471	492,896
	<b>\$ 1,614,614</b>	<b>\$ 1,134,622</b>

**NOTE 6:- INVENTORIES**

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Raw and packaging materials	\$ 6,043,170	\$ 4,556,250
Work in progress	1,583,790	3,186,843
Finished products	260,860	108,727
	<b>\$ 7,887,820</b>	<b>\$ 7,851,820</b>

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

**NOTE 7:- PROPERTY AND EQUIPMENT, NET**

a. Composition of property and equipment is as follows:

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Cost:		
Computers and related equipment	\$ 2,494,370	\$ 2,080,462
Motor vehicles	561,737	674,737
Office furniture and equipment	1,194,132	1,015,054
Machinery, equipment and installations	4,485,959	4,108,763
Buildings	1,172,072	-
Land	115,538	-
Leasehold improvements	846,271	887,311
Demo inventory	1,150,129	643,458
	<u>\$ 12,020,208</u>	<u>\$ 9,409,785</u>
Accumulated depreciation:		
Computers and related equipment	2,061,044	1,626,066
Motor vehicles	249,627	234,023
Office furniture and equipment	536,472	585,069
Machinery, equipment and installations	3,132,202	2,466,598
Buildings	25,045	-
Leasehold improvements	407,030	385,196
Demo inventory	528,992	372,240
	<u>6,940,412</u>	<u>5,669,192</u>
Depreciated cost	<u>\$ 5,079,796</u>	<u>\$ 3,740,593</u>

b. Depreciation expense amounted to \$1,376,749 and \$1,966,748 for the years ended December 31, 2007 and 2006, respectively.

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

As for liens, see Note 11.d.

**NOTE 8:- GOODWILL AND OTHER INTANGIBLE ASSETS, NET**

a. Goodwill

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

	<b>12/31/06</b>	<b>Additions</b>	<b>Adjustments</b> <b>(currency)</b>	<b>12/31/07</b>
Simulation	\$ 24,235,419	\$ -	\$ -	\$ 24,235,419
Battery	5,413,210	-	533,439	5,946,649
Armor	1,066,596	-	109,467	1,176,063
Total	<u>\$ 30,715,225</u>	<u>\$ -</u>	<u>\$ 642,906</u>	<u>\$ 31,358,131</u>

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

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

b. Other intangible assets

	December 31,			
	2007		2006	
	Cost	Net Book Value	Cost	Net Book Value
Technology	\$ 6,405,000	\$ 2,305,000	\$ 6,405,000	\$ 2,898,750
Capitalized software costs	1,720,991	442,816	1,701,150	975,664
Backlog	682,000	–	682,000	–
Covenants not to compete	99,000	–	99,000	9,900
Customer list	7,548,645	3,846,117	7,548,645	4,591,065
Certification	246,969	–	246,969	51,877
	<u>16,702,605</u>	<u>6,593,933</u>	<u>16,682,764</u>	<u>8,527,256</u>
Exchange differences	444,143		175,958	
Less - accumulated amortization	<u>(10,108,672)</u>		<u>(8,155,508)</u>	
Amortized cost	7,038,076		8,703,214	
Trademarks	<u>799,000</u>		<u>799,000</u>	
Net book value	<u>\$ 7,837,076</u>		<u>\$ 9,502,214</u>	

Amortization expense amounted to \$1,953,164 and \$2,857,891 for the years ended December 31, 2007 and 2006, respectively, including amortization of capitalized software costs of \$552,689 and \$285,467, respectively.

c. Estimated amortization expenses, except capitalized software costs, for the years ended

Year ended December 31,	
<b>2008</b>	\$ 1,276,075
<b>2009</b>	1,235,632
<b>2010</b>	1,197,990
<b>2011</b>	1,197,990
<b>2012</b>	621,740
<b>2013 and forward</b>	<u>621,691</u>
Total	<u>\$ 6,151,117</u>

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

**NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS**

The Company and/or certain of its subsidiaries have \$8.0 million authorized in credit lines from certain banks, of which \$475,000 is denominated in NIS and carries various approximate interest rates of prime rate + 2.6 to 4.2% and \$7.5 million is denominated in U.S. dollars (the Company's primary line) and carries an interest rate of lender's prime rate + 0.25%, the interest rate charged by the bank for this line was 7.5% at December 31, 2007. As of December 31, 2007, \$5.1 million was utilized from the Company's primary line, out of which \$530,000 is related to two letters of credit issued to customers of two of the Company's subsidiaries.

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

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

These lines of credit are secured by the accounts receivable, inventory and marketable securities of the relevant subsidiary of the Company.

**NOTE 10:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Employees and payroll accruals	\$ 1,531,157	\$ 1,288,601
Accrual for expected loss	–	829,973
Accrued vacation pay	530,850	442,068
Accrued expenses	1,813,947	1,380,150
Government authorities	401,826	815,374
Advances from customers	611,948	414,889
	<u>\$ 4,889,728</u>	<u>\$ 5,171,055</u>

**NOTE 11:– COMMITMENTS AND CONTINGENT LIABILITIES**

a. Royalty commitments:

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

Royalties paid or accrued for the years ended December 31, 2007 and 2006 to the OCS amounted to \$15,063 and \$30,402, respectively.

As of December 31, 2007, the total contingent liability to the OCS was approximately \$10,356,671. The Company regards the probability of this contingency coming to pass in any material amount to be low.

2. EFL, in cooperation with a U.S. participant, has received approval from the Israel-U.S. Bi-national Industrial Research and Development Foundation ("BIRD-F") for 50% funding of a project for the development of a hybrid propulsion system for transit buses. The maximum approved cost of the project is approximately \$1.8 million, and the EFL's share in the project costs is anticipated to amount to approximately \$1.1 million, which will be reimbursed by BIRD-F at the aforementioned rate of 50%. Royalties at rates of 2.5%-5% of sales are payable up to a maximum of 150% of the grant received, linked to the U.S. Consumer Price Index. Accelerated royalties are due under certain circumstances.

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**In U.S. dollars**

**NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2007.

As of December 31, 2007, the total contingent liability to pay BIRD-F (150%) was approximately \$772,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

b. Lease commitments:

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

	<b>December 31</b>
2008	\$ 637,760
2009	495,504
2010	502,031
2011	507,349
2012	513,875
Thereafter	1,645,672
<b>Total</b>	<b>\$ 4,302,191</b>

Total rent expenses for the years ended December 31, 2007 and 2006 were \$890,406 and \$878,908, respectively.

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

The table below details the original value, depreciation and net book value of the leased assets. The net book value is included in the property and equipment totals in the balance sheet.

<b>Leased Assets</b>	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Equipment	\$ 249,532	\$ 249,532
Less: Accumulated Depreciation	(97,789)	(20,130)
<b>Net book value</b>	<b>\$ 151,743</b>	<b>\$ 229,402</b>

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

<b>Liabilities</b>	<b>December 31, 2007</b>
Obligations under capital leases:	
Current	\$ 67,543
Non-current	86,989
<b>Total</b>	<b>\$ 154,532</b>

The table below details the minimum future lease payments due along with the present value of the net minimum lease payments as of December 31, 2007.



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

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

<u>Future Minimum Lease Payments</u>	<u>December 31</u>
<b>2008</b>	\$ 67,543
<b>2009</b>	42,394
<b>2010</b>	30,017
<b>2011</b>	14,578
<b>2012 and forward</b>	–
Total minimum lease payments	<u>154,532</u>

c. Guarantees:

The Company obtained bank guarantees in the amount of \$235,000 in connection (i) obligations of two of the Company's subsidiaries to the Israeli customs authorities, (ii) the obligation of one of the Company's subsidiaries to secure the return of products loaned to the Company from one of its customers, and (iii) the obligation of one of the Company's subsidiaries to secure a required letter of credit required under a long term contract. In addition, the Company has two outstanding letters of credit in the amounts of \$334,000 and \$196,210 to two of its subsidiaries' customers.

d. Liens:

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

FAAC has a \$7.5 million line of credit secured by the assets of the Company and its active United States subsidiaries and guaranteed by the Company and its active subsidiaries.

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

e. Litigation and other claims:

As of December 31, 2007, there were no pending material legal proceedings to which the Company was a party, other than ordinary routine litigation incidental to its business, except as follows:

1. In December 2004, AoA filed an action against a U.S. government defense agency, seeking approximately \$2.2 million in damages for alleged improper termination of a contract. In its answer, the government agency counterclaimed, seeking approximately \$2.1 million in procurement and administrative costs. Trial in this matter is in progress. At this stage in the proceedings, the Company and its legal advisors cannot determine with any certainty whether AoA will have any liability and, if so, the extent of that liability.

2. In May 2007, two purported class action complaints (the "Complaint") were filed in the United States District Court for the Eastern District of New York against the Company and certain of its officers and directors. These two cases were consolidated in June 2007. A similar case filed

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

in the United States District Court for the Eastern District of Michigan in March 2007 was withdrawn by the plaintiff in June 2007. The Complaint seeks class status on behalf of all persons who purchased the Company's securities between November 9, 2004 and November 14, 2005 (the "Period") and alleges violations by the Company and certain of its officers and directors of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, primarily related to the Company's acquisition of AoA in 2005 and certain public statements made by the Company with respect to its business and prospects during the Period. The Complaint also alleges that the Company did not have adequate systems of internal operational or financial controls, and that the Company's financial statements and reports were not prepared in accordance with GAAP and SEC rules. The Complaint seeks an unspecified amount of damages. A lead plaintiff has been named, and the plaintiff's consolidated amended complaint was filed in September 2007. The Company's motion to dismiss the complaint was filed in November 2007, but a decision on its motion is not expected until mid-2008. Although the ultimate outcome of this matter cannot be determined with certainty, the Company believes that the allegations stated in the Complaint are without merit and the Company and its officers and directors named in the Complaint intend to defend themselves vigorously against such allegations.

**NOTE 12:- CONVERTIBLE DEBT, DETACHABLE WARRANTS AND OTHER LONG TERM DEBT**

As of July 31, 2007, all convertible notes had been repaid in full

- a. 8% Secured Convertible Debentures due September 30, 2006 and issued in September 2003

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$5.0 million due September 30, 2006. These debentures were convertible at any time prior to September 30, 2006 at a conversion price of \$16.10 per share, or a maximum aggregate of 310,559 shares of common stock.

As part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 89,286 shares of common stock at any time prior to September 30, 2006 at a price of \$20.125 per share. In March 2006, 8,929 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 3,571 shares at an exercise price of \$8.316. As a result of this repricing of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$24,531.

This transaction was accounted according to APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments." The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 1.95%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

---

**In U.S. dollars**

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

In connection with these convertible debentures, the Company recorded a deferred debt discount of \$2,963,043 with respect to the beneficial conversion feature and the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date – September 30, 2006 – or to the actual conversion date, if earlier, as financial expenses.

During 2006, the Company recorded an expense of \$22,142 which was attributable to amortization of debt discount and beneficial conversion feature related to the convertible debenture over its term. These expenses were included in the financial expenses.

During 2006, the Company paid the remaining principal amount of \$150,000 in respect of these secured convertible debentures.

b. 8% Secured Convertible Debentures due September 30, 2006 and issued in December 2003

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$6.0 million due September 30, 2006. These debentures were convertible at any time prior to September 30, 2006 at a conversion price of \$20.30 per share, or a maximum aggregate of 295,567 shares of common stock.

As a further part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 107,143 shares of common stock at any time prior to December 18, 2006 at a price of \$25.375 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 74,143 shares of common stock at any time prior to December 31, 2006 at a price of \$30.80 per share. In February and March 2006, an aggregate of 55,607 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holders of these warrants received new warrants to purchase an aggregate of 22,244 shares at an exercise price of \$8.316. In April 2006, 11,121 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 4,449 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$39,221.

This transaction was accounted according to APB No. 14 “Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants” and Emerging Issue Task Force No. 00-27 “Application of Issue No. 98-5 to Certain Convertible Instruments.” The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.45%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of \$6,000,000 with respect to the beneficial conversion feature and the discount arising from fair

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

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

value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date – September 30, 2006 – or to the actual conversion date, if earlier, as financial expenses.

During 2006, the Company recorded an expense of \$1,168,573 which was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term. These expenses were included in the financial expenses.

During 2006, the Company paid in cash the remaining principal amount of \$4,387,500 in respect of these secured convertible debentures.

c. Senior Secured Convertible Notes due March 31, 2008

Pursuant to the terms of a Securities Purchase Agreement dated September 29, 2005 (the “Purchase Agreement”) by and between the Company and certain institutional investors, the Company issued and sold to the investors an aggregate of \$17.5 million principal amount of senior secured convertible notes (“Notes”) having a final maturity date of March 31, 2008.

Under the terms of the Purchase Agreement, as amended, the Company granted the investors (i) a second position security interest in the assets and receivables of FAAC Incorporated, and in the receivables of MDT Armor Corporation related to MDT’s David order with the U.S. Army (junior to the security interest of a bank that had, at that time, extended to FAAC Corporation a \$6.0 million line of credit) and (ii) a first position security interest in the assets of all of the Company’s other active United States subsidiaries and in the stock of all of the Company’s active United States subsidiaries, as well as in any stock that the Company acquires in future Acquisitions (as defined in the securities purchase agreement). The Company’s active United States subsidiaries are also acting as guarantors of the Company’s obligations under the Notes. Since the senior notes were paid in full during 2007, these security interests no longer apply.

The Notes are convertible at the investors’ option at a fixed conversion price of \$14.00. The Notes bear interest at a rate equal to six month LIBOR plus 6% per annum, subject to a floor of 10% and a cap of 12.5%. The Company was obligated to repay the principal amount of the Notes over a period of two and one-half years, with the principal amount being amortized in twelve payments payable in cash and/or, at the Company’s option, in stock by forcing conversion of the Notes, provided certain conditions are met. In the event of an election by the Company to make such payments in stock by forcing conversion of the notes, the price used to determine the number of shares to be issued was 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.

As a further part of the Securities Purchase Agreement dated September 29, 2005, the Company issued warrants, which were not exercisable for the six month period following closing, to purchase up to 375,000 shares of common stock (30% warrant coverage) at an exercise price of \$15.40 per share. These warrants were exercisable until March 29, 2007.

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

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

This transaction was accounted according to APB No. 14, “Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants” and Emerging Issue Task Force No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments” (“EITF 00-27”). The fair value of the warrants granted in respect of convertible debentures was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.87%, a volatility factor 53%, dividend yields of 0% and a contractual life of one year.

In connection with these Notes, the Company recorded a deferred debt discount of \$422,034 with respect to the discount arising from fair value allocation of the warrants according to APB No. 14, which was amortized from the date of issuance to the stated redemption date – March 31, 2008 – or the actual conversion date, if earlier, as financial expenses

The Company has also considered EITF No. 05-2, “The Meaning of Conventional Convertible Debt Instrument” in EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.” Accordingly, the Company has concluded that these convertible notes would be considered as conventional convertible debt.

As to EITF No. 00-19, since the terms of the warrants referred to above provided that upon exercise of a warrant the Company could issue only stock that had been registered with the SEC (which occurred in December 2005) and therefore freely tradable, in accordance with Emerging Issues Task Force No 00-19 “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. The fair value of these warrants was remeasured as at December 31, 2005 using the Black-Scholes pricing model assuming a risk free interest rate of 3.87%, a volatility factor of 64%, dividend yields of 0% and a contractual life of approximately nine months

The Notes provide for repayment in twelve equal installments. Installments may be paid in cash or, at the Company’s option (subject to certain conditions), in stock. If the Company elects to make a payment in stock, it must give notice 24 trading days prior to the date the installment is due, and issue shares of its stock to the holders of the Note based on a conversion price of \$14.00. Thereafter, based on a price of 92% of the average price of the stock during 17 of the trading days between the notice date and the installment payment date, the Company issues additional shares based on the amount, if any, by which the average price of the stock was less than \$14.00.

As a result of a prepayment conversion in April 2006, the Company made the final payment in respect of the Notes in July 2007.

During 2007 and 2006, the Company recorded expenses of \$18,745 and \$1,485,015, respectively, attributable to amortization related to warrants issued to the holders of the Notes and the beneficial conversion feature. During 2007 and 2006, the Company also recorded expenses of \$280,382 and \$5,395,338, respectively, attributable to financial expenses in connection with convertible debenture principle repayment of the Notes. Additionally, during 2007 and 2006, the

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

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

Company recorded expenses of \$44,253 and \$780,719, respectively, attributable to amortization of deferred charges related to issuance of the Notes.

During 2007 and 2006, the Company issued a total of 930,125 and 4,184,855 shares, respectively, in payment of the debentures.

d. Other Long Term Debt:

1. Mortgage Note, Auburn, Alabama:

In March 2007, the Company purchased 16,700 square feet of space in Auburn, Alabama for approximately \$1.1 million pursuant to a seller-financed secured purchase money mortgage. Half the mortgage is payable over ten years in equal monthly installments based on a 20-year amortization of the full principal amount, and the remaining half is payable at the end of ten years in a balloon payment. The note requires a payment (principal and interest) of approximately \$9,300 per month at an interest rate of 8% per annum. The balance of this note is shown in the short and long term sections of the balance sheet.

<b>Mortgage Future Payments</b>	
2008	\$ 25,021
2009	27,105
2010	29,355
2011	31,792
2012	34,423
Thereafter	950,101
	<u>\$ 1,097,797</u>

The Company has additional long term debt outstanding of approximately \$95,000, primarily vehicle loans. This amount is payable \$79,000 in 2008 and \$15,000 in 2009.

**NOTE 13:– STOCKHOLDERS' EQUITY**

a. Stockholders' rights:

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

b. Warrants:

1. In March 2006, 19,625 of the Company's warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received new warrants to purchase 7,850 shares at an exercise price of \$8.316. As a result of this repricing of the existing warrants and the issuance of these new warrants, the Company recorded during 2006 a deemed dividend in the amount of \$28,369.

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)**

2. In January 2004, in connection with a purchase of the Company's securities by certain investors, the Company granted three-year warrants to purchase up to an aggregate of 702,888 shares of the Company's common stock at any time beginning six months after closing at an exercise price per share of \$26.32.

In July 2004 an aggregate of 531,915 shares were issued pursuant to exercise of these warrants. In connection with the exercise of the warrants, the Company granted to the same investors five-year warrants to purchase up to an aggregate of 531,915 shares of the Company's common stock at an exercise price per share of \$19.32. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years.

In March 2006, 56,991 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase an aggregate of 22,796 shares at an exercise price of \$8.316. In April 2006, an additional 75,988 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 30,395 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$270,336.

3. On July 14, 2004, warrants to purchase 629,588 shares of common stock, having an aggregate exercise price of \$16,494,194, net of issuance expenses, were exercised. Out of the shares issued in conjunction with the exercise of these warrants, 80,357 shares were issued upon exercise of warrants issued in connection with the Company's former 8% Secured Convertible Debentures due September 30, 2006 and 531,915 shares were issued upon exercise of warrants issued in the transaction referred to in the Note 13.b.2. above; the remaining 17,316 shares were issued upon exercise of a warrant that the Company issued to an investor in May 2001. In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 622,662 new five-year warrants to purchase shares of common stock at an exercise price of \$19.32 per share

In February and March 2006, an aggregate of 501,216 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holders of these warrants received new warrants to purchase an aggregate of 200,487 shares at an exercise price of \$8.316. In April 2006, an additional 16,071 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 6,429 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 deemed dividend in the amount of \$71,728.

As to EITF 00-19, since the terms of the new warrants referred to above provided that the warrants were exercisable subject to the Company obtaining shareholder approval, in accordance with Emerging Issues Task Force No 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," their fair value was recorded as

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)**

a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date until obtaining shareholder approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the shareholder approval), using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$700,113 has been recorded as finance income.

4. On February 4, 2004, the Company entered into an agreement settling the litigation brought against it in the Tel-Aviv, Israel district court by I.E.S. Electronics Industries, Ltd. ("IES Electronics") and certain of its affiliates in connection with the Company's purchase of the assets of its IES Interactive Training, Inc. subsidiary from IES Electronics in August 2002. The litigation had sought monetary damages in the amount of approximately \$3.0 million. Pursuant to the terms of the settlement agreement, in addition to agreeing to dismiss their lawsuit with prejudice, IES Electronics agreed (i) to cancel the Company's \$450,000 debt to them that had been due on December 31, 2003, and (ii) to transfer to the Company title to certain certificates of deposit in the approximate principal amount of \$112,000. The parties also agreed to exchange mutual releases. In consideration of the foregoing, the Company issued to IES Electronics (i) 32,143 shares of common stock, and (ii) five-year warrants to purchase up to an additional 32,143 shares of common stock at a purchase price of \$26.74 per share. The fair value of the warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of five years. The fair value of warrants was calculated as \$483,828 and fair value of shares as \$765,000.

5. As of December 31, 2007, the Company's outstanding warrants totaled 493,851 with expiration dates through July 2009 with exercise prices ranging from \$8.32 to \$31.50.

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

1. 1998 Employee Option Plan – as amended, 339,286 shares reserved for issuance, of which 86,194 were available for future grants to employees and consultants as of December 31, 2007.

2. 1995 Non-Employee Director Plan – 71,429 shares reserved for issuance, of which 71,429 stock options were issued and outstanding as of December 31, 2007. Pursuant to the terms of this Plan, no new options were issuable under this Plan after September 28, 2005.

3. 2004 Employee Option Plan – 535,714 shares reserved for issuance, of which 277,351 were available for future grants to employees and consultants as of December 31, 2007.

4. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 708,882 were available for future grants to outside directors as of December 31, 2007.



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

**NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)**

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

Restricted stock generally vests over three years. Half of these shares are subject only to service requirements and half vest subject to service and performance requirements. The performance requirements are determined annually by the Board. These performance requirements were met in 2007 but have not been determined for future years. Shares subject to performance requirements carryover to subsequent years if the performance requirements are not met in a particular year. Vesting will not occur if the performance requirements are never met. In the event that employment is terminated prior to vesting, all unvested restricted shares revert back to the Company.

6. A summary of the status of the Company's plans and other share options and restricted shares (except for options granted to consultants) granted as of December 31, 2007 and 2006, and changes during the years ended on those dates, is presented below:

Stock Options:

	2007		2006	
	Amount	Weighted average exercise price \$	Amount	Weighted average exercise price \$
Options outstanding at beginning of year	623,686	\$ 8.20	606,068	\$ 10.23
Changes during year:				
Granted (1) (2)	–	\$ –	124,000	\$ 2.86
Exercised	–	\$ –	(1,786)	\$ 0.14
Forfeited	(332,305)	\$ 13.34	(104,596)	\$ 13.75
Options outstanding at end of year	291,381	\$ 2.34	623,686	\$ 8.20
Options vested at end of year	222,260	\$ 2.47	486,526	\$ 9.22
Options expected to vest	55,296	\$ 2.34	109,728	\$ 8.20

(1) Includes 0 and 12,500 options granted to directors and executive officers in 2007 and 2006, respectively.

(2) Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2007 and 2006 was \$1,417,521 and \$500,545, respectively.

The table below summarizes the intrinsic value of options for each year.

	Vested	Unvested
2007 <sup>(1)</sup>	\$ –	\$ –
2006	\$ 1,039	\$ 31,220

<sup>(1)</sup>Calculated intrinsic value is less than zero.

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

**NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)**

Restricted Shares:

	2007		2006	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
Nonvested at the beginning of the year	863,572	\$ 2.51	54,286	\$ 1.41
Changes during year:				
Granted	436,118	\$ 2.51	860,000	\$ 2.58
Vested	(500,238)	\$ 2.62	(48,571)	\$ 1.42
Forfeited	—	\$ —	(2,143)	\$ 1.73
Nonvested at the end of the year	799,452	\$ 2.38	863,572	\$ 2.51
Restricted shares vested at end of year	548,809	\$ 2.51	48,571	\$ 1.42

7. The options outstanding as of December 31, 2007 have been separated into ranges of exercise price, as follows:

Range of exercise prices	Total options outstanding			Vested options outstanding	
	Amount outstanding at December 31, 2007	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2007	Weighted average exercise price
		Years	\$		\$
0.00-28.00	289,483	3.71	2.14	220,362	2.20
28.01-56.00	1,898	1.96	34.24	1,898	34.24
Total	291,381	3.70	2.35	222,260	2.47

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

	Equals market price		Less than market price	
	Year ended December 31,		Year ended December 31,	
	2007	2006	2007	2006
Weighted average exercise prices	\$ —	\$ 2.86	\$ —	\$ —
Weighted average fair value on grant date	\$ —	\$ 2.11	\$ —	\$ —

9. Options issued to consultants:

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

	2007		2006	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
Options outstanding at beginning of year	11,878	\$ 53.20	11,878	\$ 53.20
Changes during year:				
Granted	—	\$ —	10,000	\$ 1.90
Exercised	—	\$ —	(10,000)	\$ 1.90
Forfeited or cancelled	—	\$ —	—	\$ —
Options outstanding at end of year	11,878	\$ 53.20	11,878	\$ 53.20
Options vested at end of year	11,878	\$ 53.20	11,878	\$ 53.20

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)**

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

	<u>2006</u>
Dividend yield	0%
Expected volatility	84.8%
Risk-free interest	4.58%
Contractual life of up to	1 year

In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling \$0 and \$6,563 for the years ended December 31, 2007 and 2006, respectively, and included these amounts in general and administrative expenses.

10. The remaining total compensation cost related to non-vested stock options and restricted share awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2007 was \$2,294,727, of which \$90,457 was for stock options and \$2,204,271 was for restricted shares. The weighted average period over which this compensation cost is expected to be recognized is approximately 2 years.

d. Dividends:

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

e. Treasury Stock:

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

**NOTE 14:- INCOME TAXES**

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

As of December 31, 2007, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$21.2 million, which are available to offset future taxable income, if any, expiring in 2009 through 2027. Utilization of U.S net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company did not record a liability for unrecognized tax positions. The adoption of FIN 48 did not impact the Company's financial condition, results of operations or cash flows. At December 31, 2007, the Company had net deferred tax assets of \$36.8 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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 14:– INCOME TAXES (Cont.)**

future taxable income to realize these assets, a full valuation has been established to offset its net deferred tax asset. Additionally, the future utilization of the Company's NOL carryforwards to offset future taxable income is subject to a substantial annual limitation as a result of ownership changes that that has occurred. The Company has completed a Section 382 analysis regarding the limitation of the net operating losses and has 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 DTA and corresponding valuation allowance were reduced by \$4,185,516 for the U.S. federal NOLs and by \$3,555,231 for the state NOLs. The Company has also reevaluated the unrecognized tax benefits under FIN 48 after the completion of the Section 382 analysis. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in our unrecognized tax benefits will not impact the Company's effective tax rate.

At least three years of the Company's federal returns are still open for examination, so it is possible that the amount of this liability could change in future accounting periods.

The Company files income tax returns, including returns for its subsidiaries, with federal, state, local and foreign jurisdictions. The Company is no longer subject to IRS examination for periods prior to 2003, although carryforward losses that were generated prior to 2002 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 2002.

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

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

b. Israeli subsidiary (Epsilon):

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

Currently, Epsilon is operating under two programs as follows:

1. Program one:

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 14:- INCOME TAXES (Cont.)**

The approved expansion program is in the amount of approximately \$600,000. Epsilor effectively operated the program during 2002, and is entitled to the tax benefits available under the Investments Law (commencing from 2003).

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

Those benefits are limited to 12 years from the year that the enterprise began operations, or 14 years from the year in which the approval was granted, whichever is earlier. Hence, this approved program will expire in 2009.

2. Program two:

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law, and is entitled to investments grants from the State of Israel in the amount of 32% on property and equipment located at its Dimona plant.

The approved expansion program is in the amount of approximately \$945,000. This program has not yet received final approval.

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

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

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

3. As stated above for each specific program

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

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 31%.

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, 2007 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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 14:– INCOME TAXES (Cont.)**

liability was recorded as of December 31, 2007. 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. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

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 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, 2007, the Company did not generate income under the provision of the amended Investment Law.

c. Other tax information about the Israeli subsidiaries:

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

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

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

EFL and Epsilon 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.

3. Tax rates applicable to income from other sources:

Income from sources other than the “Approved Enterprise,” is taxed at the regular rate of 34%. See also Note 14.e.

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**In U.S. dollars**

**NOTE 14:- INCOME TAXES (Cont.)**

4. Tax loss carryforwards:

As of December 31, 2007, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$106 million, which are available, indefinitely, to offset future taxable income.

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

Until December 31, 2003, the regular tax rate applicable to income of companies (which are not entitled to benefits due to "approved enterprise", as described above) was 36%. In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the Knesset (Israeli parliament) and on July 25, 2005, another law was passed, the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

e. Deferred income taxes:

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

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Operating loss carryforward <sup>(1)</sup>	\$ 33,741,900	\$ 33,222,692
Other temporary differences	<u>4,088,598</u>	<u>7,192,079</u>
Net deferred tax asset before valuation allowance	37,830,498	40,414,771
Valuation allowance	<u>(37,752,789)</u>	<u>(40,356,739)</u>
<b>Total deferred tax asset</b>	<b>\$ 77,709</b>	<b>\$ 58,032</b>
Deferred tax liability	<u>\$ 1,020,000</u>	<u>\$ 900,000</u>

(1)	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Domestic	\$ 7,216,709	\$ 11,627,401
Foreign	26,525,191	21,595,291
	<u>\$ 33,741,900</u>	<u>\$ 33,222,692</u>

We have 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 we are unable, at this time, to estimate the amount. Accrued income taxes on the undistributed earnings of domestic subsidiaries and affiliates are not provided because dividends received from domestic companies are expected to be non-taxable.

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax assets related to the loss carryforwards

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 14:- INCOME TAXES (Cont.)**

and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2007 was \$(2,723,950).

f. Loss from continuing operations before taxes on income and minorities interests in loss (earnings) of a subsidiary:

	<b>Year ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Domestic	\$ 2,464,512	\$ 13,014,325
Foreign	365,711	2,340,082
	<u>\$ 2,830,223</u>	<u>\$ 15,354,407</u>

g. Taxes on income were comprised of the following:

	<b>Year ended December 31</b>	
	<b>2007</b>	<b>2006</b>
Current state and local taxes	\$ 111,162	\$ 225,371
Deferred taxes	100,323	6,788
Taxes in respect of prior years	(47,569)	-
	<u>\$ 163,916</u>	<u>\$ 232,159</u>
Domestic	\$ 189,930	\$ 49,383
Foreign	(26,014)	182,776
	<u>\$ 163,916</u>	<u>\$ 232,159</u>

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



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

**NOTE 14:– INCOME TAXES (Cont.)**

	<b>Year ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Loss from continuing operations before taxes, as reported in the consolidated statements of income	\$ (2,830,223)	\$ (15,354,407)
Statutory tax rate	34%	34%
Theoretical income tax on the above amount at the U.S. statutory tax rate	\$ (962,276)	\$ (5,220,498)
Deferred taxes on losses for which valuation allowance was provided	955,412	2,745,964
Non-deductible expenses	126,864	2,793,214
Foreign non-deductible expenses	27,748	–
State taxes	69,930	49,383
Foreign income in tax rates other than U.S rate	(5,969)	(141,822)
Taxes in respect of prior years	(47,569)	–
Others	(224)	5,918
Actual tax expense	\$ 163,916	\$ 232,159

**NOTE 15:– SELECTED STATEMENTS OF OPERATIONS DATA**

Financial income (expenses), net:

	<b>Year ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Financial expenses:		
Interest, bank charges and fees	\$ (662,789)	\$ (2,018,061)
Amortization related to warrants issued to the holders of convertible debentures and beneficial conversion feature	(18,745)	(1,485,015)
Expenses in connection with convertible debenture principle repayment	(280,382)	(5,395,338)
Bonds premium amortization	–	–
Other	(91,625)	(35,332)
Foreign currency translation differences	–	–
	(1,053,540)	(8,933,746)
Financial income:		
Interest	53,298	646,583
Foreign currency translation differences	94,354	67,150
Financial income in connection with warrants granted (Note 12.c. and 13.b.3.)	–	700,113
Total	\$ (905,888)	\$ (7,519,900)

**NOTE 16:– SEGMENT INFORMATION**

a. General:

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

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**In U.S. dollars**

**NOTE 16:– SEGMENT INFORMATION (Cont.)**

Prior to its purchase of FAAC, Epsilon and AoA, the Company had managed its business in two reportable segments organized on the basis of differences in its related products and services. With the acquisition of FAAC and Epsilon early in 2004 and AoA in August of 2004, the Company reorganized into three segments: Training and Simulation (formerly known as Simulation and Security); Armor; and Battery and Power Systems. As a result the Company restated information previously reported in order to comply with new segment reporting.

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

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

	<u>Training and Simulation</u>	<u>Armor</u>	<u>Battery and Power Systems</u>	<u>All Others</u>	<u>Total</u>
<b>2007</b>					
Revenues from outside customers	\$ 27,760,858	\$ 18,724,107	\$ 11,234,596	\$ –	\$ 57,719,561
Depreciation , amortization and impairment expenses <sup>(1)</sup>	(1,667,703)	(469,093)	(1,024,434)	(227,980)	(3,389,210)
Direct expenses <sup>(2)</sup>	(21,610,720)	(17,490,430)	(11,023,839)	(6,355,909)	(56,480,898)
Segment net income (loss)	\$ 4,482,435	\$ 764,584	\$ (813,677)	\$ (6,583,889)	(2,150,547)
Financial expenses	(14,610)	(93,292)	(176,834)	(621,152)	(905,888)
Net income (loss)	<u>\$ 4,467,825</u>	<u>\$ 671,292</u>	<u>\$ (990,511)</u>	<u>\$ (7,205,041)</u>	<u>\$ (3,056,435)</u>
Segment assets <sup>(3) (4)</sup>	<u>\$ 43,810,684</u>	<u>\$ 11,235,386</u>	<u>\$ 21,191,545</u>	<u>\$ 4,243,692</u>	<u>\$ 80,481,307</u>
<b>2006</b>					
Revenues from outside customers	\$ 21,951,337	\$ 12,571,779	\$ 8,597,623	\$ –	\$ 43,120,739
Depreciation , amortization and impairment expenses <sup>(1)</sup>	(1,708,012)	(1,077,416)	(844,431)	(350,308)	(3,980,167)
Direct expenses <sup>(2)</sup>	(18,256,934)	(13,234,826)	(8,768,086)	(6,929,985)	(47,189,831)
Segment net income (loss)	\$ 1,986,391	\$ (1,740,463)	\$ (1,014,894)	\$ (7,280,293)	\$ (8,049,259)
Financial expenses	129,908	(54,476)	50,590	(7,645,922)	(7,519,900)
Net income (loss)	<u>\$ 2,116,299</u>	<u>\$ (1,794,939)</u>	<u>\$ (964,304)</u>	<u>\$ (14,926,215)</u>	<u>\$ (15,569,159)</u>
Segment assets <sup>(3) (4)</sup>	<u>\$ 43,753,369</u>	<u>\$ 9,523,126</u>	<u>\$ 18,184,133</u>	<u>\$ 3,607,646</u>	<u>\$ 75,068,274</u>

<sup>(1)</sup> Includes depreciation of property and equipment, amortization expenses of intangible assets and impairment of goodwill and other intangible assets.

<sup>(2)</sup> Including, *inter alia*, sales and marketing, general and administrative and tax expenses.

<sup>(3)</sup> Consisting of all assets.

<sup>(4)</sup> Out of those amounts, goodwill in the Company's Training and Simulation, Battery and Power Systems and Armor Divisions stood at \$24,235,419, \$5,946,649 and \$1,176,063 as of December 31, 2007, and \$24,235,419, \$5,413,210 and \$1,066,596 as of December 31, 2006, respectively.

c. Summary information about geographic areas:

The following presents total revenues according to the location of the end customer for the years ended December 31, 2007 and 2006, and long-lived assets as of December 31, 2007 and 2006:

**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In U.S. dollars

**NOTE 16:– SEGMENT INFORMATION (Cont.)**

	2007		2006	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets
U.S. dollars				
U.S.A.	\$ 45,198,904	\$ 3,141,428	\$ 32,945,951	\$ 1,916,964
Germany	230,571	–	387,612	–
England	273,239	–	240,712	–
Thailand	–	–	–	–
India	1,153,521	–	1,388,401	–
Israel	8,239,135	1,938,368	5,658,986	1,823,629
Other	2,624,191	–	2,499,077	–
	<u>\$ 57,719,561</u>	<u>\$ 5,079,796</u>	<u>\$ 43,120,739</u>	<u>\$ 3,740,593</u>

d. Revenues from major customers:

	Year ended December 31,	
	2007	2006
Batteries and power systems:		
Customer A	6%	6%
Armor:		
Customer B	6%	5%
Customer C	19%	18%
Training and Simulation:		
Customer D	27%	34%
Customer E	6%	–

e. Revenues from major products:

	Year ended December 31,	
	2007	2006
Water activated batteries	1,629,014	1,660,521
Military batteries	9,605,582	6,937,101
Car and aircraft armoring	18,724,107	12,571,779
Simulators	27,760,858	21,951,338
Total	<u>\$ 57,719,561</u>	<u>\$ 43,120,739</u>

**NOTE 17:– ACCUMULATED OTHER COMPREHENSIVE INCOME**

Accumulated other comprehensive income consists of currency translation adjustments of \$1,495,000 and \$508,000 and unrealized gains on marketable securities of \$6,000 and \$4,000 at December 31, 2007 and 2006, respectively.

**NOTE 18:– WARRANTY**

The Company provides or sells a warranty on certain of our simulators and armored vehicles. The Company allocates a percentage of each covered system or a dollar amount per covered vehicle to our warranty reserve. The amount reserved, either percentage or fixed dollar amount is determined using historical repair costs. These calculations along with the amounts allocated are reviewed semi-annually by management.

	Accrued liability beginning of year	New accruals during year	Charges for the year	Accrued liability end of year
2006	(666,541)	(1,513,513)	1,037,053	(1,143,001)
2007	(1,143,001)	(1,310,845)	936,777	(1,517,069)



**AROTECH CORPORATION AND ITS SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**In U.S. dollars**

**NOTE 19:-- PRIOR PERIOD ADJUSTMENT**

The accumulated deficit for January 1, 2006 was increased by \$900,000 to \$143,869,964 to reflect a deferred tax liability that was created when the Company deducted goodwill on previously filed tax returns. This did not have a material impact on the Company's Consolidated Statement of Operations.

**NOTE 20:-- SUBSEQUENT EVENTS**

a. In February 2008 the Company's FAAC subsidiary acquired Realtime Technologies, Inc. (RTI), a privately-owned corporation headquartered in Royal Oak, Michigan, for a total of \$1,350,000 (\$1,250,000 in cash and \$100,000 in stock) with a 2008 earn-out (maximum of \$250,000) based on 2008 net profit.

b. In January 2008, the Company purchased the minority shareholder's in 24.5% interest in MDT Israel and his 12.0% interest in MDT Armor, as well as settling all outstanding disputes regarding severance payments, in exchange for a total of \$1.0 million.

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**FINANCIAL STATEMENT SCHEDULE**

**Arotech Corporation and Subsidiaries**

**Schedule II – Valuation and Qualifying Accounts**

For the Years Ended December 31, 2007 and 2006

Description	Balance at beginning of period	Additions charged to costs and expenses*	Balance at end of period
<b>Year ended December 31, 2007</b>			
Allowance for doubtful accounts	\$ 159,000	\$ (134,000)	\$ 25,000
Allowance for slow moving inventory	1,573,000	151,000	1,724,000
Valuation allowance for deferred taxes	40,357,000	(2,604,000)	37,753,000
<b>Totals</b>	<u>\$ 42,089,000</u>	<u>\$ (2,587,000)</u>	<u>\$ 39,502,000</u>
<b>Year ended December 31, 2006</b>			
Allowance for doubtful accounts	\$ 176,000	\$ (17,000)	\$ 159,000
Allowance for slow moving inventory	1,280,000	293,000	1,573,000
Valuation allowance for deferred taxes	34,484,000	5,873,000	40,357,000
<b>Totals</b>	<u>\$ 35,940,000</u>	<u>\$ 6,149,000</u>	<u>\$ 42,089,000</u>

\*The 2007 and 2006 valuation allowance includes an adjustment to the prior year provision calculation due to changes recognized in the preparation of the actual returns.







**Consent of Independent Registered Public Accounting Firm**

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3 (Nos. 333-95361, 333-33986, 333-37630, 333-45818, 333-49628, 333-59346, 333-63514, 333-99559, 333-99673, 333-106420, 333-110729, 333-112611, 333-124959, 333-124961, 333-128497 and 333-129713), and Form S-8 (Nos. 333-74197, 333-86728 and 333-124960) of our report dated April 14, 2008, relating to the consolidated financial statements and schedule of Arotech Corporation appearing in this Form 10-K/A for the year ended December 31, 2007.

/s/ BDO Seidman,

LLP

BDO Seidman, LLP

Grand Rapids, Michigan  
April 28, 2008

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**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert S. Ehrlich, certify that:

1. I have reviewed this amended annual report on Form 10-K of Arotech Corporation;
  2. Based on my knowledge, this amended annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amended annual report;
  3. Based on my knowledge, the financial statements, and other financial information included in this amended annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amended annual report;
  4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
    - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amended annual report is being prepared;
    - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this amended annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this amended annual report based on such evaluation (the "Evaluation Date"); and
    - (d) disclosed in this amended annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this amended annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
  5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
-

- (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 28, 2008

/s/ Robert S. Ehrlich  
Robert S. Ehrlich, Chairman and CEO  
(Principal Executive Officer)

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**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Thomas J. Paup, certify that:

1. I have reviewed this amended annual report on Form 10-K of Arotech Corporation;
  2. Based on my knowledge, this amended annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amended annual report;
  3. Based on my knowledge, the financial statements, and other financial information included in this amended annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amended annual report;
  4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
    - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amended annual report is being prepared;
    - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this amended annual report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this amended annual report based on such evaluation (the "Evaluation Date"); and
    - (d) disclosed in this amended annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this amended annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
  5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
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- (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 28, 2008

/s/ Thomas J. Paup  
Thomas J. Paup, Vice President – Finance and CFO  
(Principal Financial Officer)

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**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the amended Annual Report of Arotech Corporation (the "Company") on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission (the "Report"), I, Robert S. Ehrlich, Chairman and Chief Executive Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify that the amended Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the amended Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Robert S.

Ehrlich

Robert S. Ehrlich  
Chairman and CEO  
(Chief Executive Officer)

Date: April 28, 2008

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**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the amended Annual Report of Arotech Corporation (the "Company") on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission (the "Report"), I, Thomas J. Paup, Vice President – Finance and Chief Financial Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify that the amended Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the amended Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ Thomas J.

Paup

Thomas J. Paup  
Vice President – Finance and Chief Financial Officer  
(Chief Financial Officer)

Date: April 28, 2008

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