| OMB APPROVAL | |
|---|---|
| OMB Number: | 3235-0070 |
| Expires: | March 31, 2006 |
| Estimated average burden hours per response..... | 192.00 |

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2004.

COMMISSION FILE NUMBER: 0-23336

AROTECH CORPORATION

(Exact name of registrant as specified in its charter)

| DELAWARE | 95-4302784 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| 250 WEST 57TH STREET, SUITE 310, NEW YORK, NEW YORK | 10107 |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

(212) 258-3222
(Registrant's telephone number, including area code)

(Former address, if changed since last report)

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 [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares outstanding of the issuer's common stock as of August 10, 2004 was 79,078,483.

AROTECH CORPORATION

INDEX

ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED BALANCE SHEETS
(U.S. DOLLARS)

<TABLE>
<CAPTION>

| ASSETS | JUNE 30, 2004 (Unaudited) | DECEMBER 31, 2003 (Note 1.b.) |
|---|---|---|
| <S> | <C> | <C> |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 5,119,706 | $13,685,125 |
| Restricted securities and deposits due within one year | 8,890,772 | 706,180 |
| Available-for-sale marketable securities | 126,577 | -- |
| Trade receivables (net of allowance for doubtful accounts in the amounts of $70,087 and $61,282 as of June 30, 2004 and December 31, 2003, respectively) | 4,895,028 | 4,706,423 |
| Current portion of note receivable | 306,116 | -- |
| Unbilled revenues | 1,571,315 | -- |
| Other accounts receivable and prepaid expenses | 1,882,041 | 1,187,371 |
| Inventories | 6,825,858 | 1,914,748 |
| Assets of discontinued operations | 59,981 | 66,068 |
| TOTAL CURRENT ASSETS | 29,677,394 | 22,265,915 |
| SEVERANCE PAY FUND | 1,812,665 | 1,023,342 |
| PROPERTY AND EQUIPMENT, NET | 3,258,571 | 2,292,741 |
| RESTRICTED SECURITIES AND DEPOSITS | 2,000,000 | -- |
| LONG TERM RECEIVABLES | 818,805 | -- |
| GOODWILL | 14,322,067 | 5,064,555 |
| OTHER INTANGIBLE ASSETS, NET | 13,203,311 | 2,375,195 |
| | $65,092,813 | $33,021,748 |

</TABLE>

The accompanying notes are an integral part of the Consolidated Financial Statements.



AROTECH CORPORATION
CONSOLIDATED BALANCE SHEETS
(U.S. DOLLARS, EXCEPT SHARE DATA)

<TABLE>
<CAPTION>

| LIABILITIES AND SHAREHOLDERS' EQUITY | JUNE 30, 2004 (Unaudited) | DECEMBER 31, 2003 (Note 1.b.) |
|---|---|---|
| <S> | <C> | <C> |
| CURRENT LIABILITIES: | | |
| Trade payables | $ 3,909,475 | $ 1,967,448 |
| Other accounts payable and accrued expenses | 4,861,404 | 4,180,411* |
| Current portion of promissory notes due to purchase of subsidiaries | 1,070,037 | 150,000 |
| Short-term bank loans and current portion of long-term loans | 367,427 | 40,849 |
| Deferred revenues | 3,553,219 | 140,936* |
| Liabilities of discontinued operations | 268,609 | 380,108 |
| TOTAL CURRENT LIABILITIES | 14,030,171 | 6,859,752 |
| LONG TERM LIABILITIES | | |
| Accrued severance pay | 3,253,740 | 2,814,492 |

| | | |
|---|---|---|
| Convertible debentures | 737,235 | 881,944 |
| Deferred warranty revenue, less current portion | 169,369 | 220,143 |
| Long-term loan | 7,265 | -- |
| Promissory notes due to purchase of subsidiaries | 2,110,616 | 150,000 |
| TOTAL LONG-TERM LIABILITIES | 6,278,225 | 4,066,579 |
| MINORITY INTEREST | 77,192 | 51,290 |
| SHAREHOLDERS' EQUITY: | | |
| Share capital - | | |
| Common stock - $0.01 par value each; Authorized: 250,000,000 shares as of June 30, 2004 and December 31, 2003; Issued: 66,012,516 shares as of June 30, 2004 and 47,972,407 shares as of December 31, 2003; Outstanding - 65,457,183 shares as of June 30, 2004 and 47,417,074 shares as of December 31, 2003 | 660,127 | 479,726 |
| Preferred shares - $0.01 par value each; Authorized: 1,000,000 shares as of June 30, 2004 and December 31, 2003; No shares issued and outstanding as of June 30, 2004 and December 31, 2003 | -- | -- |
| Additional paid-in capital | 167,789,043 | 135,891,316 |
| Deferred stock compensation | (492,240) | (8,464) |
| Accumulated deficit | (118,366,463) | (109,681,893) |
| Treasury stock, at cost (common stock - 555,333 shares as of June 30, 2004 and December 31, 2003) | (3,537,106) | (3,537,106) |
| Notes receivable on account of shares | (1,211,776) | (1,203,881) |
| Accumulated other comprehensive income (loss) | (134,360) | 104,429 |
| TOTAL SHAREHOLDERS' EQUITY | 44,707,225 | 22,044,127 |
| | $ 65,092,813 | $ 33,021,748 |

</TABLE>

- --------
* Reclassified.

- ---

The accompanying notes are an integral part of the Consolidated Financial Statements.



AROTECH CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(U.S. DOLLARS, EXCEPT SHARE DATA)

<TABLE>
<CAPTION>
- ---

| | SIX MONTHS ENDED JUNE 30, | | THREE MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| <S> | <C> | <C> | <C> | <C> |
| Revenues | $ 17,110,502 | $ 7,526,588 | $ 9,928,248 | $ 3,493,135 |
| Cost of revenues | 11,131,967 | 5,112,889 | 6,574,747 | 2,479,170 |
| Gross profit | 5,978,535 | 2,413,699 | 3,353,501 | 1,013,965 |
| Operating expenses: | | | | |
| Research and development | 871,627 | 510,544 | 408,121 | 152,505 |
| Selling and marketing | 2,140,696 | 1,637,576 | 1,119,611 | 933,589 |
| General and administrative | 7,202,454 | 2,473,507 | 3,521,461 | 1,460,752 |
| Amortization of intangible assets | 992,025 | 623,543 | 496,013 | 311,771 |
| Total operating costs and expenses | 11,206,802 | 5,245,170 | 5,545,206 | 2,858,617 |
| Operating loss | (5,228,267) | (2,831,471) | (2,191,705) | (1,844,652) |
| Financial expenses, net | (3,259,530) | (983,821) | (1,985,576) | (725,609) |
| Loss before taxes | (8,487,797) | (3,815,292) | (4,177,281) | (2,570,261) |
| Tax expenses, net | (170,065) | (277,047) | (174,972) | (274,185) |
| Loss before minority interest in loss (earnings) of a subsidiary and tax expenses | (8,657,862) | (4,092,339) | (4,352,253) | (2,844,446) |
| Minority interest in loss (earnings) of a subsidiary | (26,708) | 160,298 | (26,162) | 203,526 |
| Loss from continuing operations | (8,684,570) | (3,932,041) | (4,378,415) | (2,640,920) |
| Profit from discontinued operations | -- | 83,166 | -- | 179,127 |
| Net loss | $ (8,684,570) | $ (3,848,875) | $ (4,378,415) | $ (2,461,793) |
| Basic and diluted net loss per share from continuing operations | $ (0.14) | $ (0.11) | $ (0.07) | $ (0.07) |

| | | | | |
|---|---|---|---|---|
| Basic and diluted net profit per share from ..... discontinued operations | $ -- | $ 0.00 | $ -- | $ 0.00 |
| Combined basic and diluted net loss per share .... | $ (0.14) | $ (0.11) | $ (0.07) | $ (0.07) |
| Weighted average number of shares used in computing basic and diluted net loss per share . | 62,035,532 | 35,678,067 | 64,490,090 | 36,209,872 |

</TABLE>

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The accompanying notes are an integral part of the Consolidated Financial Statements.



AROTECH CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(U.S. DOLLARS, EXCEPT SHARE DATA)

<TABLE>
<CAPTION>

| | COMMON STOCK | | ADDITIONAL PAID-IN | DEFERRED STOCK | ACCUMULATED | TREASURY |
|---|---|---|---|---|---|---|
| | SHARES | AMOUNT | CAPITAL | COMPENSATION | DEFICIT | STOCK |
| <S> | <C> | <C> | <C> | <C> | <C> | <C> |
| BALANCE AT JANUARY 1, 2004 - .... NOTE 1 | 47,972,407 | $ 479,726 | $ 135,891,316 | $ (8,464) | $(109,681,893) | $ (3,537,106) |
| CHANGES DURING THE SIX-MONTH PERIOD ENDED JUNE 30, 2004 | | | | | | |
| Issuance of shares, net ..... | 10,290,426 | 102,904 | 18,412,219 | -- | -- | -- |
| Investment in subsidiary against issuance of shares . | 1,003,856 | 10,039 | 1,993,639 | -- | -- | -- |
| Conversion of convertible debentures ..... | 3,213,292 | 32,133 | 3,035,583 | -- | -- | -- |
| Exercise of warrants ..... | 2,549,107 | 25,491 | 3,868,332 | -- | -- | -- |
| Issuance of shares to consultants ..... | 74,215 | 742 | 170,477 | -- | -- | -- |
| Compensation related to options and warrants issued to consultants and investors ..... | -- | -- | 2,376,212 | -- | -- | -- |
| Compensation related to non-recourse loan granted to shareholder ..... | -- | -- | 13,500 | -- | -- | -- |
| Exercise of options by employees ..... | 841,598 | 8,416 | 1,042,724 | -- | -- | -- |
| Exercise of options by consultants ..... | 27,615 | 276 | 38,399 | -- | -- | -- |
| Shares issued to employee .... | 40,000 | 400 | 92,800 | -- | -- | -- |
| Deferred stock compensation .. | -- | -- | 845,947 | (845,947) | -- | -- |
| Amortization of deferred stock compensation ..... | -- | -- | -- | 362,171 | -- | -- |
| Interest accrued on notes receivable from shareholders ..... | -- | -- | 7,895 | -- | -- | -- |
| Other comprehensive loss - foreign currency translation adjustment ..... | -- | -- | -- | -- | -- | -- |
| Other comprehensive loss - changes in marketable securities ..... | -- | -- | -- | -- | -- | -- |
| Net loss ..... | -- | -- | -- | -- | (8,684,570) | -- |
| Total comprehensive loss ..... | -- | -- | -- | -- | -- | -- |
| BALANCE AT JUNE 30, 2004 - UNAUDITED ..... | 66,012,516 | $ 660,127 | $ 167,789,043 | $ (492,240) | $(118,366,463) | $ (3,537,106) |

</TABLE>

<TABLE>
<CAPTION>

| | NOTES RECEIVABLE FROM SHAREHOLDERS | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | TOTAL COMPREHENSIVE LOSS | TOTAL |
|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> |
| BALANCE AT JANUARY 1, 2004 - .... NOTE 1 | $ (1,203,881) | $ 104,429 | $ -- | $ 22,044,127 |
| CHANGES DURING THE SIX-MONTH | | | | |

| PERIOD ENDED JUNE 30, 2004 | | | | |
|---|---|---|---|---|
| Issuance of shares, net | -- | -- | -- | 18,515,123 |
| Investment in subsidiary against issuance of shares | -- | -- | -- | 2,003,678 |
| Conversion of convertible debentures | -- | -- | -- | 3,067,716 |
| Exercise of warrants | -- | -- | -- | 3,893,823 |
| Issuance of shares to consultants | -- | -- | -- | 171,219 |
| Compensation related to options and warrants issued to consultants and investors | -- | -- | -- | 2,376,212 |
| Compensation related to non-recourse loan granted to shareholder | -- | -- | -- | 13,500 |
| Exercise of options by employees | -- | -- | -- | 1,051,140 |
| Exercise of options by consultants | -- | -- | -- | 38,675 |
| Shares issued to employee | -- | -- | -- | 93,200 |
| Deferred stock compensation | -- | -- | -- | -- |
| Amortization of deferred stock compensation | -- | -- | -- | 362,171 |
| Interest accrued on notes receivable from shareholders | (7,895) | -- | -- | -- |
| Other comprehensive loss - foreign currency translation adjustment | -- | (239,809) | (239,809) | (239,809) |
| Other comprehensive loss - changes in marketable securities | -- | 1,020 | 1,020 | 1,020 |
| Net loss | -- | -- | (8,684,570) | (8,684,570) |
| Total comprehensive loss | -- | -- | -- | -- |
| BALANCE AT JUNE 30, 2004 - UNAUDITED | $ (1,211,776) | $ (134,360) | $ (8,923,359) | $ 44,707,225 |

</TABLE>

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The accompanying notes are an integral part of the Consolidated Financial Statements.



AROTECH CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED) (U.S. DOLLARS)

<TABLE>
<CAPTION>
- ---

| | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|
| | 2004 | 2003 |
| <S> | <C> | <C> |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss for the period | $ (8,684,570) | $ (3,848,875) |
| Net loss for the period from discontinued operations | -- | (83,166) |
| Adjustments required to reconcile net loss to net cash used in operating activities: | | |
| Depreciation | 518,332 | 348,401 |
| Amortization of intangible assets | 992,025 | 623,543 |
| Amortization of deferred financial expenses | -- | *157,500 |
| Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature | 2,967,791 | *878,572 |
| Amortization of deferred expenses related to convertible debenture issuance | 160,414 | *132,034 |
| Amortization of capitalized research and development projects | 18,326 | -- |
| Amortization of compensation related to options granted to consultants | -- | 29,759 |
| Stock-based compensation due to grant and repricing of warrants granted to investors | 1,742,384 | -- |
| Stock-based compensation due to options and shares granted to employees | 428,861 | -- |
| Stock-based compensation due to shares granted to consultants | -- | 154,331 |
| Write-off of inventory | 112,395 | 26,000 |
| Profit (loss) to minority | 26,708 | (160,298) |
| Impairment of fixed assets | -- | 62,332 |
| Mark-up of loans to shareholders | (32,397) | -- |
| Interest expenses (income) accrued on promissory notes due to purchase of subsidiary | 14,668 | (38,966) |
| Capital gain from sale of marketable securities | (4,103) | -- |
| Interest accrued on certificates of deposit due within one year | (101,569) | -- |
| Amortization of premium related to restricted securities | 89,743 | -- |
| Accrued interest on long-term loan | 382 | -- |

| | | |
|---|---|---|
| Capital gain from sale of property and equipment | (5,744) | (3,163) |
| Accrued severance pay, net | (436,974) | (10,023) |
| Increase in deferred tax assets | (16,453) | -- |
| Changes in operating asset and liability items: | | |
| Decrease in trade receivables | 2,439,972 | 242,923 |
| Increase in unbilled revenues | (270,927) | -- |
| Decrease in notes receivable | 154,952 | -- |
| Increase in accounts receivable | (675,608) | *(158,255) |
| Increase in inventories | (3,742,621) | (323,595) |
| Increase (decrease) in trade payables | 987,471 | (455,504) |
| Increase in deferred revenues | 2,749,306 | -- |
| Decrease in accounts payable and accruals | (548,134) | (72,676) |
| NET CASH USED IN OPERATING ACTIVITIES FROM CONTINUING OPERATIONS (RECONCILED FROM CONTINUING OPERATIONS) | (1,115,370) | (2,499,126) |
| NET CASH USED IN OPERATING ACTIVITIES FROM DISCONTINUED OPERATIONS (RECONCILED FROM DISCONTINUED OPERATIONS) | (105,408) | (391,388) |
| NET CASH USED IN OPERATING ACTIVITIES | (1,220,778) | (2,890,514) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Repayment of promissory note related to purchase of subsidiary | (75,000) | (750,000) |
| Investment in subsidiary(1) | (7,190,777) | -- |
| Investment in subsidiary(2) | (12,125,953) | -- |
| Proceeds from sale of marketable securities, net | 812 | -- |
| Repayment of loan granted to shareholder | 32,397 | -- |
| Purchase of property and equipment | (636,775) | (270,603) |
| Increase in capitalized research and development projects | (153,357) | *(101,894) |
| Proceeds from sale of property and equipment | 59,036 | 7,586 |
| Decrease in demo inventories, net | 11,201 | 10,317 |
| Decrease (increase) in restricted securities and deposits, net | (9,792,408) | 585,034 |
| NET CASH USED IN INVESTING ACTIVITIES | (29,870,824) | (519,560) |
| FORWARD | $(31,091,602) | $ (3,410,074) |

</TABLE>

- ---------
* Reclassified.

- ---
The accompanying notes are an integral part of the Consolidated Financial Statements.



AROTECH CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED) (U.S. DOLLARS)

<TABLE>
<CAPTION>

| | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|
| | 2004 | 2003 |
| <S> | <C> | <C> |
| FORWARD | $(31,091,602) | $ (3,410,074) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Decrease in short-term credit from banks | (165,245) | (91,001) |
| Proceeds from issuance of share capital, net | 17,741,739 | -- |
| Proceeds from exercise of options | 1,089,815 | -- |
| Proceeds from exercise of warrants | 3,893,823 | 1,325,837 |
| Payment on capital lease obligation | (1,550) | -- |
| Repayment of long-term loans | (28,192) | -- |
| Issuance of convertible debenture | -- | *3,238,662 |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 22,530,390 | 4,473,498 |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (8,561,212) | 1,063,424 |
| CASH EROSION DUE TO EXCHANGE RATE DIFFERENCES | (4,207) | (17,995) |
| BALANCE OF CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD | 13,685,125 | 1,457,526 |
| BALANCE OF CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD | $ 5,119,706 | $ 2,502,955 |
| SUPPLEMENTARY INFORMATION ON NON-CASH TRANSACTIONS: | | |
| Issuance of shares and warrants against accrued expenses | $ 1,460,394 | $ -- |
| Exercise of options and warrants against notes receivable | $ -- | $ 99,394 |
| Increase in restricted deposit due within one year | $ 110,114 | |

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED) (U.S. DOLLARS)

| | | |
|---|---|---|
| Investment in subsidiary against promissory note ..... | $ 2,940,985 | $ -- |
| Exercise of convertible debentures against shares ..... | $ 3,112,500 | $ 1,500,000 |
| Compensation related to issuance of warrants in connection with convertible debenture and beneficial conversion feature of convertible debentures ..... | $ -- | $ 1,890,000 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOWS INFORMATION - CASH PAID DURING THE PERIOD FOR: | | |
| Interest ..... | $ (273,836) | $ (22,290) |

</TABLE>

- ---------
* Reclassified.

(1) In January 2004, the Company acquired substantially all of the outstanding ordinary shares of Epsilor Electronic Industries, Ltd. ("Epsilor"). The net fair value of the assets acquired and the liabilities assumed, at the date of acquisition, was as follows:

| | |
|---|---|
| Working capital, excluding cash and cash equivalents (unaudited) ..... | $ (533,750) |
| Fixed assets (unaudited) ..... | 709,847 |
| Intangible assets and goodwill (unaudited) ..... | 9,955,665 |
| | 10,131,762 |
| Issuance of promissory note (unaudited) ..... | (2,940,985) |
| | $ 7,190,777 |

- ---

The accompanying notes are an integral part of the Consolidated Financial Statements.





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(2) In January 2004, the Company acquired all of the outstanding common stock of FAAC Incorporated ("FAAC"). The net fair value of the assets acquired was as follows:

| | |
|---|---|
| Working capital, excluding cash and cash equivalents (unaudited) | $ 2,647,822 |
| Fixed assets (unaudited) ..... | 263,669 |
| Intangible assets and goodwill (unaudited) ..... | 11,221,290 |
| | 14,132,781 |
| Issuance of shares, net (unaudited) ..... | (2,006,828) |
| | $ 12,125,953 |

- ---

The accompanying notes are an integral part of the Consolidated Financial Statements.





NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1: BASIS OF PRESENTATION

a. Company:

Arotech Corporation, formerly known as Electric Fuel Corporation ("Arotech" or the "Company"), and its subsidiaries provide defense and security products for the military, law enforcement and homeland security markets, including advanced zinc-air and lithium batteries and chargers, multimedia interactive simulators/trainers and lightweight vehicle armoring. The Company is primarily operating through IES Interactive Training Systems, Inc., a wholly-owned subsidiary based in Littleton, Colorado; 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; Epsilor Electronic Industries, Ltd., a wholly-owned subsidiary located in Dimona, Israel; M.D.T. Protective Industries, Ltd., a majority-owned subsidiary based in Lod, Israel; MDT Armor Corporation, a majority-owned subsidiary based in Auburn, Alabama; and

Armour of America, Incorporated, a wholly-owned subsidiary based in Los Angeles, California (see also Note 13.c).

b. Basis of presentation:

The accompanying interim consolidated financial statements have been prepared by Arotech Corporation in accordance with generally accepted accounting principles in the United States and the rules and regulations of the Securities and Exchange Commission, and include the accounts of Arotech Corporation and its subsidiaries. Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States, have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company, the unaudited financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the financial position at June 30, 2004 and the operating results and cash flows for the six months ended June 30, 2004 and 2003.

The results of operations for the six months ended June 30, 2004 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending December 31, 2004.

The balance sheet at December 31, 2003 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements.

c. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and FASB No. Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's stock options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.





Under Statement of Financial Accounting Standard No. 123 "Accounting for Stock-Based Compensation ("SFAS No. 123"), pro forma information regarding net income and net earnings per share is required, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123. The fair value for these options is amortized over their vesting period and estimated at the date of grant using a Black-Scholes Option Valuation Model with the following weighted-average assumptions for the six and three months ended June 30, 2004 and 2003:

| | SIX MONTHS ENDED JUNE 30, | | THREE MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| | (Unaudited) | | | |
| Risk free interest | 3.81 | 1.0% | 3.81 | 1.0% |
| Dividend yields | 0.0% | 0.0% | 0.0% | 0.0% |
| Volatility | 0.817 | 0.538 | 0.817 | 0.538 |
| Expected life | 5 years | 4 years | 5 years | 4 years |

Pro forma information under SFAS No. 123:

<TABLE>
<CAPTION>

| | SIX MONTHS ENDED JUNE 30, | | THREE MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| | Unaudited (U.S. Dollars, except per share data) | | | |
| <S> | <C> | <C> | <C> | <C> |
| Net loss as reported | $ (8,684,570) | $ (3,848,875) | $ (4,378,415) | $(2,461,793) |
| Add: Stock-based compensation expense determined under fair value method for all awards, net of related tax effects | $ (859,600) | $ (1,413,157) | $ (649,317) | $ (701,776) |
| Pro forma net loss | $ (9,544,170) | $ (5,262,032) | $ (5,027,732) | $(3,163,569) |
| Loss per share: | | | | |
| Basic and diluted, as reported | $ (0.14) | $ (0.11) | $ (0.07) | $ (0.07) |
| Pro forma basic and diluted | $ (0.15) | $ (0.15) | $ (0.08) | $ (0.09) |

| | | | |
|---|---|---|---|
| ========== | ========== | ========== | ========== |

</TABLE>

NOTE 2: ACQUISITION OF EPSILOR

In January of 2004, the Company entered into a stock purchase agreement between itself and all of the shareholders of Epsilor Electronic Industries, Ltd. ("Epsilor"), pursuant to the terms of which the Company purchased all of the outstanding stock of Epsilor from Epsilor's existing shareholders. Epsilor develops and sells rechargeable and primary lithium batteries and smart chargers to the military, and to private industry in the Middle East, Europe and Asia. The total consideration of $10,000,000 for the shares purchased consisted of (i) cash in the amount of $7,000,000, and (ii) a series of three $1,000,000 promissory notes, due on the first, second and third anniversaries of the agreement, which were recorded at their fair value of $2,940,985.

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





| | |
|---|---|
| Tangible assets acquired | $ 2,360,968 |
| Intangible assets | |
| Technology | 159,364 |
| Customer list | 4,889,671 |
| Goodwill | 4,906,629 |
| Liabilities assumed | (2,184,870) |
| Total consideration | $ 10,131,762 |

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

NOTE 3: ACQUISITION OF FAAC

In January of 2004, the Company entered into a stock purchase agreement with the shareholders of FAAC Incorporated ("FAAC"), pursuant to the terms of which it acquired all of the issued and outstanding common stock of FAAC, a leading provider of driving simulators, systems engineering and software products to the United States military, government and private industry.

The consideration for the purchase consisted of (i) cash in the amount of $12.0 million, and (ii) the issuance of a total of 1,003,856 shares of our common stock, $0.01 par value per share, having a value of $2.0 million. Additionally, there is an earn-out based on 2004 net pretax profit, with an additional earn-out on the 2005 net profit from certain specific and limited programs. The total consideration of $14.0 million was determined based upon arm's-length negotiations between the Company and FAAC's shareholders.

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

| | |
|---|---|
| Tangible assets acquired | $ 5,682,334 |
| Intangible assets | |
| Technology | 4,610,000 |
| Existing contracts | 636,000 |
| Website | 14,000 |
| Customer list | 1,125,000 |
| Trademarks | 360,000 |
| Goodwill | 4,476,290 |
| Liabilities assumed | (2,770,843) |
| Total consideration | $ 14,132,781 |

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from acquisitions will not be amortized. In lieu of amortization, Arotech is required to perform an annual and interim impairment review. If Arotech determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its





statement of operations. Arotech will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may

not be recoverable.

NOTE 4: PRO FORMA FINANCIAL INFORMATION

In January 2004, the Company acquired FAAC and Epsilor, as more fully described in "Note 2 - Acquisition of Epsilor" and "Note 3 - Acquisition of FAAC," above (the "Acquisitions"). The following summary pro forma information includes the effects of the Acquisitions. The pro forma data for the six months ended June 30, 2004 and 2003 are presented as if the Acquisitions had been completed on January 1, 2004 and 2003, respectively. This pro forma financial information does not purport to be indicative of the results of operations that would have occurred had the Acquisitions taken place at the beginning of the period, nor do they purport to be indicative of the results that will be obtained in the future.

| | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|
| | 2004 | 2003 |
| | (IN THOUSANDS, EXCEPT PER SHARE DATA) (Unaudited) | |
| Total revenues | $ 17,110,502 | $ 14,815,271 |
| Gross profit | 5,978,535 | 6,228,001 |
| Net loss | (8,684,570) | (3,331,221) |
| Basic and diluted net loss per share | $ (0.14) | $ (0.09) |

NOTE 5: INVENTORIES

Inventories are stated at the lower of cost or market value. Cost is determined using the average cost method. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on these evaluations, provisions are made in each period to write down inventory to its net realizable value. Inventories write-offs are provided to cover risks arising from slow-moving items, technological obsolescence, excess inventories, and for market prices lower than cost. In the six months ended June 30, 2004 the Company wrote off inventory in the amount of $112,395, which has been included in cost of revenues. Inventories are composed of the following:

| | JUNE 30, 2004 | DECEMBER 31, 2003 |
|---|---|---|
| | (Unaudited) | (Note 1.b.) |
| Raw materials | $3,426,661 | $ 657,677 |
| Work-in-progress | 1,549,027 | 634,221 |
| Finished goods | 1,850,170 | 622,850 |
| | $6,825,858 | $1,914,748 |

NOTE 6: IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN No. 46") which clarifies the application of Accounting Research Bulletin (ARB) No. 51, "Consolidated Financial Statements," relating to consolidation of certain entities. First, FIN No. 46 will require identification of the Company's participation in variable interest entities (VIEs), which are defined as entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a stand-alone basis, or whose equity holders lack certain characteristics of a



controlling financial interest. Then, for entities identified as VIEs, FIN No. 46 sets forth a model to evaluate potential consolidation based on an assessment of which party to the VIE, if any, bears a majority of the exposure to its expected losses, or stands to gain from a majority of its expected returns. FIN No. 46 is effective for all new VIEs created or acquired after January 31, 2003. For VIEs created or acquired prior to February 1, 2003, the provisions of FIN No. 46 must be applied for the first interim or annual period beginning after December 15, 2003. FIN No. 46 also sets forth certain disclosures regarding interests in VIEs that are deemed significant, even if consolidation is not required. The adoption of FIN No. 46 has not had a material impact on the Company's results of operations or financial position.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS No. 149"). SFAS No. 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 has not had a material impact on the Company's results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS No. 150"). SFAS No. 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatory redeemable stock; certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003 and must be applied to the Company's existing financial instruments effective July 1, 2003, the beginning of the first fiscal period after June 15, 2003. The adoption of SFAS No. 150 has not had a material effect on the Company's financial position, results of operations or cash flows.

In March 2004, the Financial Accounting Standards Board (FASB) approved the consensus reached on the Emerging Issues Task Force (EITF) Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," The objective of this Issue is to provide guidance for identifying impairment investments. EITF 03-1 also provides new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting provisions of EITF 03-1 are effective for all reporting periods beginning after June 15, 2004, while the disclosure requirements are effective only for annual periods ending after June 15, 2004. The Company has evaluated the impact of the adoption of EITF 03-1 and does not believe the impact will be significant to the Company's overall results of operations or financial position.

NOTE 7: SEGMENT INFORMATION

a. General:

The Company and its subsidiaries operate primarily in three business segments and follow the requirements of SFAS No. 131.





The Company previously 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 Epsilor early in 2004, the Company reorganized into three segments: Simulation, Training and Consulting; Battery and Power Systems; and Armored Vehicles. As a result the Company reclassified information previously reported in order to comply with new segment reporting.

The Company's reportable operating segments have been determined in accordance with the Company's internal management structure, which is organized based on operating activities. The accounting policies of the operating segments are the same as those of the Company. 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 revenues, income (losses) and assets for the six and three months ended June 30, 2004 and 2003 (in U.S. dollars):

<TABLE>
<CAPTION>

| | SIMULATION, TRAINING AND CONSULTING | BATTERY AND POWER SYSTEMS | ARMORED VEHICLES | ALL OTHERS | TOTAL |
|---|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> | <C> |
| SIX MONTHS ENDED JUNE 30, 2004 | | | | | |
| Revenues from outside customers | $ 7,224,644 | $ 5,132,390 | $ 4,753,468 | $ -- | $ 17,110,502 |
| Depreciation expenses and amortization | (808,243) | (563,991) | (59,123) | (79,000) | (1,510,357) |
| Direct expenses (1) | (6,937,321) | (5,077,918) | (4,404,993) | (4,603,365) | (21,023,597) |
| Segment gross profit (loss) | $ (520,920) | $ (509,519) | $ 289,352 | $ (4,682,365) | (5,423,452) |
| Financial expenses (after deduction of minority interest) | | | | | (3,261,118) |
| Net loss from continuing operations | | | | | $ (8,684,570) |
| Segment assets | 18,569,441 | 13,114,218 | 5,424,216 | 501,931 | 37,609,806 |
| SIX MONTHS ENDED JUNE 30, 2003 | | | | | |
| Revenues from outside customers | $ 2,841,365 | $ 2,853,081 | $ 1,832,142 | $ -- | $ 7,526,588 |
| Depreciation expenses and amortization | (543,643) | (226,048) | (107,253) | (95,000) | (971,944) |
| Direct expenses (1) | (3,019,651) | (2,758,443) | (1,929,912) | (1,802,135) | (9,510,141) |
| Segment gross profit (loss) | $ (721,929) | $ (131,410) | $ (205,023) | $ (1,897,135) | (2,955,497) |
| Financial expenses (after deduction of minority interest) | | | | | (976,544) |
| Net loss from continuing operations | | | | | $ (3,932,041) |
| Segment assets | 6,660,699 | 2,225,796 | 2,312,119 | 432,298 | 11,630,912 |

| | | | | | |
|---|---|---|---|---|---|
| | ========== | ========== | ========== | ========== | ========== |

</TABLE>





<TABLE>
<CAPTION>

| | SIMULATION, TRAINING AND CONSULTING | BATTERY AND POWER SYSTEMS | ARMORED VEHICLES | ALL OTHERS | TOTAL |
|---|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> | <C> |
| THREE MONTHS ENDED JUNE 30, 2004 | | | | | |
| Revenues from outside customers | $ 4,012,561 | $ 2,626,768 | $ 3,288,919 | $ -- | $ 9,928,248 |
| Depreciation expenses and amortization | (423,142) | (281,121) | (29,673) | (44,000) | (777,936) |
| Direct expenses (1) | (3,769,830) | (2,613,958) | (3,022,974) | (2,136,969) | (11,543,731) |
| Segment gross profit (loss) | $ (180,411) | $ (268,311) | $ 236,272 | $ (2,180,969) | (2,393,419) |
| Financial expenses (after deduction of minority interest) | | | | | (1,984,996) |
| Net loss from continuing operations | | | | | $ (4,378,415) |
| THREE MONTHS ENDED JUNE 30, 2003 | | | | | |
| Revenues from outside customers | $ 882,919 | $ 2,024,437 | $ 585,779 | $ -- | $ 3,493,135 |
| Depreciation expenses and amortization | (271,821) | (107,024) | (53,736) | (47,000) | (479,581) |
| Direct expenses (1) | (1,294,416) | (1,766,753) | (779,638) | (1,082,590) | (4,923,397) |
| Segment gross profit (loss) | $ (683,318) | $ 150,660 | $ (247,595) | $ (1,129,590) | (1,909,843) |
| Financial expenses (after deduction of minority interest) | | | | | (731,077) |
| Net loss from continuing operations | | | | | $ (2,640,920) |

</TABLE>

- ---------
(1) Including sales and marketing, general and administrative and tax expenses.
(2) Consisting of property and equipment, inventory and intangible assets.

NOTE 8: CONVERTIBLE DEBENTURES

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

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

During the six months ended June 30, 2004, the remaining $1,150,000 of 9% secured convertible debentures outstanding was converted into an aggregate of 1,796,875 shares of common stock.

In determining whether the convertible debentures include a beneficial conversion feature in accordance with EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Continently Adjustable Conversion Ratios" and EITF 00-27, the total proceeds were allocated to the convertible debentures and the detachable warrants based on their relative fair values. In connection with these convertible debentures, the Company recorded financial expenses of $600,000 with respect to the beneficial conversion feature. The $600,000 was amortized from the date of issuance to the actual conversion date as financial expenses.

During the six months ended June 30, 2004, the Company recorded an expense of $118,286, all which was attributable to amortization due to conversion of the convertible debenture into shares.





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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company, in September 2003, 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 are convertible at any time prior to September 30, 2006 at a conversion price of $1.15 per share, or a maximum aggregate of 4,347,826 shares of common stock (see also Note 9.b).

During the six months ended June 30,2004, a total of $350,000 principal amount of debentures was converted, at a conversion price of $1.15 per share.

In determining whether the convertible debentures include a beneficial conversion option in accordance with EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Continently Adjustable Conversion Ratios" and EITF 00-27, the total proceeds were allocated to the convertible debentures and the detachable warrants based on their relative fair values. In connection with these convertible debentures, the Company will record financial expenses of $1,938,043 with respect to the beneficial conversion feature. The $1,938,043 is amortized from the date of issuance to the stated redemption date - September 30, 2006 - as financial expenses.

During the six months ended June 30, 2004 the Company recorded an expense of $180,595, of which $68,574 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term, and $112,021 of which was attributable to amortization due to conversion of the convertible debentures into shares. These expenses were included in the financial expenses.

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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company, in December 2003, 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 are convertible at any time prior to September 30, 2006 at a conversion price of $1.45 per share, or a maximum aggregate of 4,137,931 shares of common stock (see also Note 9.c).

During the six months ended June 30,2004, a total of $1,612,500 principal amount of debentures was converted, at a conversion price of $1.45 per share.

In determining whether the convertible debentures include a beneficial conversion option in accordance with EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Continently Adjustable Conversion Ratios" and EITF 00-27, the total proceeds were allocated to the convertible debentures and the detachable warrants based on their relative fair values. In connection with these convertible debentures, the Company will record financial expenses of $3,157,500 with respect to the beneficial conversion feature. The $3,157,500 is amortized from the date of issuance to the stated redemption date - September 30, 2006 - as financial expenses.



During the six months ended June 30, 2004 the Company recorded an expense of $1,208,832, of which $480,468 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term, and $728,364 of which was attributable to amortization due to conversion of the convertible debentures into shares. These expenses were included in the financial expenses.

NOTE 9: WARRANTS

a. Warrants issued in connection with the 9% Secured Convertible Debentures due June 30, 2005

As part of the securities purchase agreement on December 31, 2002 (see Note 8.a), the Company issued to the purchasers of its 9% secured convertible debentures due June 30, 2005, warrants, as follows: (i) Series A Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.84 per share; (ii) Series B Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.89 per share; and (iii) Series C Warrants to purchase an aggregate of 1,166,700 shares of common stock at any time prior to December 31, 2007 at a price of $0.93 per share. The exercise price of these warrants was adjusted to $0.64 per share in April 2003.

In connection with these warrants, the Company recorded a deferred debt discount of $1,290,000, which will be amortized ratably over the life of the convertible debentures (3 years), unless these warrants are exercised, in which case any remaining financial expense will be taken in the quarter in which the exercise occurs. This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 64%, dividend yields of 0% and a contractual life of 5 years.

During the six months ended June 30, 2004, the Company recorded an expense of $147,428 for amortization of these debt discounts over their term, which is included in financial expenses.

b. Warrants issued in connection with the 8% Secured Convertible Debentures due

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

In connection with these warrants, the Company recorded a deferred debt discount of $1,025,000, which will be amortized ratably over the life of the convertible debentures (3 years). This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 1.95%, a volatility factor 98%, dividend yields of 0% and a contractual life of 3 years.





During the six months ended June 30, 2004, an aggregate of 687,500 shares were issued pursuant to exercises of these warrants.

During the six months ended June 30, 2004, the Company recorded an expense of $533,448, of which $61,537 was attributable to amortization of the debt discount over their term and $471,911 was attributable to amortization due to exercise of warrants. Those expenses were included in the financial expenses.

c. Warrants issued in connection with 8% Secured Convertible Debentures due December 31, 2006

As a further part of the securities purchase agreement on September 30, 2003 (see Note 8.c), the Company issued to the purchasers of its 8% secured convertible debentures due December 31, 2006, warrants to purchase an aggregate of 1,500,000 shares of common stock at any time prior to December 31, 2006 at a price of $1.8125 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 1,038,000 shares of common stock at any time prior to June 18, 2009 at a price of $2.20 per share.

During the six months ended June 30, 2004 an aggregate of 375,000 shares were issued pursuant to exercise of these warrants.

In connection with these warrants, the Company will record financial expenses of $1,545,000 and $1,297,500 for the additional and the supplemental warrants referred to above, respectively, which will be amortized ratably over the life of the convertible debentures (3 years). This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 2.45%, a volatility factor 98%, dividend yields of 0% and a contractual life of 3 years.

During the six months ended June 30, 2004, the Company recorded an expense of $779,201 of which $442,053 was attributable to amortization of these debt discounts over their term and $337,148 was attributable to amortization due to exercise of warrants. These expenses were included in financial expenses.

d. Warrants issued to an investor

In November 2000 and May 2001, the Company issued a total of 916,667 warrants to an investor, which warrants contained certain antidilution provisions: a Series A warrant to purchase 666,667 shares of the Company's common stock at a price of $3.50 per share, and a Series C warrant to purchase 250,000 shares at a price of $3.08 per share. Operation of the antidilution provisions provided that the Series A warrant should be adjusted to be a warrant to purchase 888,764 shares at a price of $2.67 per share, and the Series C warrant should be adjusted to be a warrant to purchase 333,286 shares at a price of $2.35 per share. After negotiations, the investor agreed to exercise its warrants immediately, in exchange for a lowering of the exercise price to $1.45 per share, and the issuance of a new six-month Series D warrant to purchase 1,222,050 shares at an exercise price of $2.10 per share. The new Series D warrant would not have similar antidilution provisions. As a result of this repricing and the issuance of these new warrants, the Company recorded a compensation expense in the amount of approximately $1,299,690 in the first six months of 2004.





NOTE 10: AMENDMENT TO CERTIFICATE OF INCORPORATION

In June 2004, the Company amended Article Four of its Amended and Restated Certificate of Incorporation to increase the number of shares of common stock that the Company is authorized to issue from 100,000,000 to 250,000,000, pursuant to the affirmative vote of the Company's Board of Directors and

shareholders.

NOTE 11: ISSUANCE OF SHARES AND WARRANTS

Pursuant to the terms of a Securities Purchase Agreement dated January 7, 2004 by and between the Company and several institutional investors, the Company issued and sold (i) an aggregate of 9,840,426 shares of the Company's common stock at a purchase price of $1.88 per share, and (ii) three-year warrants to purchase up to an aggregate of 9,840,426 shares of the Company's common stock at any time beginning six months after closing at an exercise price per share of $1.88. Gross proceeds of this offering were approximately $18.5 million (see also Note 13.b).

NOTE 12: LITIGATION SETTLEMENT

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. 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 IES Electronics 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.

In consideration of the foregoing, the Company issued to IES Electronics (i) 450,000 shares of its common stock, and (ii) five-year warrants to purchase up to an additional 450,000 shares of its common stock at a purchase price of $1.91 per share.

NOTE 13: SUBSEQUENT EVENTS

a. Exercise of warrants and issuance of new warrants:

In July 2004, warrants to purchase 8,814,235 shares of common stock, having an aggregate exercise price of $16,494,194, were exercised. In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 8,717,265 new five-year warrants to purchase shares of common stock at an exercise price of $1.38 per share.

b. Issuance of common stock to investors:

In July 2004, the Company issued to a group of investors an aggregate of 4,258,065 shares of common stock at a price of $1.55 per share, or a total purchase price of $6,600,000



c. Acquisition of Armour of America Incorporated:

In August 2004, the Company purchased all of the outstanding stock of Armour of America, Incorporated, a California corporation ("AoA"), from AoA's existing shareholder. The assets acquired through the purchase of all of AoA's outstanding stock consisted of all of AoA's assets, including AoA's current assets, property and equipment, and other assets (including intangible assets such as goodwill, intellectual property and contractual rights). The consideration for the assets purchased consisted of cash in the amount of $22,000,000, with additional possible earn-outs of up to $18,000,000 based on 2004 net pretax profit and on the receipt by AoA of certain specific and limited material contracts.



ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This report contains forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements 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," below, and in our other filings with the Securities and Exchange Commission.

Arotech(TM) is a trademark and Electric Fuel(R) is a registered trademark of Arotech Corporation. All company and product names mentioned may be trademarks or registered trademarks of their respective holders. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and its subsidiaries.

The following discussion and analysis should be read in conjunction with the interim financial statements and notes thereto appearing elsewhere in this Quarterly Report. 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.

EXECUTIVE SUMMARY

DIVISIONS AND SUBSIDIARIES

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

>> Our SIMULATION, TRAINING AND CONSULTING DIVISION, which develops, manufactures and markets advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement and security personnel, as well as offering security consulting and other services, consisting of:

- IES Interactive Training, Inc., located in Littleton, Colorado, which provides specialized "use of force" training for police, security personnel and the military ("IES");
- FAAC Incorporated, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry ("FAAC"); and



- Arocon Security Corporation, located in New York, New York, which provides security consulting and other services, focusing on protecting life, assets and operations with minimum hindrance to personal freedom and daily activities ("Arocon").

>> Our BATTERY AND POWER SYSTEMS DIVISION, which manufactures and sells Zinc-Air and lithium batteries for defense and security products and other military applications and pioneers advancements in Zinc-Air battery technology for electric vehicles, consisting of:

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

>> Our ARMORED VEHICLE DIVISION, which utilizes sophisticated lightweight materials and advanced engineering processes to armor vehicles, consisting of:

- MDT Protective Industries, Ltd., located in Lod, Israel, which specializes in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and cars, and is a leading supplier to the Israeli military, Israeli special forces and special services ("MDT") (75.5% owned by us);
- MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT's United States activities ("MDT Armor") (88% owned by us); and
- Armour of America (see also Note 13.c), located in Los Angeles, California, which manufacturers aviation armor both for helicopters and for fixed wing aircraft, marine armor, personnel armor, armoring kits for military vehicles, fragmentation blankest and a unique

ballistic/flotation vest (ArmourFloat) that is U.S. Coast Guard-certified ("AoA").

OVERVIEW OF RESULTS OF OPERATIONS

We incurred significant operating losses for the years ended December 31, 2001, 2002 and 2003 and for the first six months of 2004. While we expect to continue to derive revenues from the sale of products that our subsidiaries manufacture and the services that they provide, there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis.





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

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

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

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

As a result of the application of the above accounting rule, we incurred non-cash charges related to our acquisitions in the amount of $992,025 during the first six months of 2004.

The non-cash charges that relate to our financings occurred in connection with our sale of convertible debentures with warrants. When we issue convertible debentures, we record an expense 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 debentures, we record an expense for financial expenses that is amortized ratably over the term of the warrant; when the warrant is exercised, the entire remaining unamortized financial expense is immediately recognized in the quarter in which the warrant is exercised. As and to the extent that our remaining convertible debentures and warrants are converted and exercised, we would incur similar non-cash charges going forward.





As a result of the application of the above accounting rule, we incurred non-cash charges related to our financings in the amount of $2,967,791 during the first six months of 2004.

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

As a result of the application of the above accounting rule we incurred non-cash charges related to warrants repricing in amount of $1,299,690 during the first six months of 2004. These expenses were included in general and

administrative expenses.

In addition, we incurred non-cash charges in the amount of $442,694 during the first six months of 2004 as a result of warrants granted to some of our investors in the past. We also incurred non-cash charges in the amount of $428,861 in connection with options and shares granted to employees. These expenses were included in general and administrative expenses.

RECENT DEVELOPMENTS

In August 2004, we purchased all of the outstanding stock of Armour of America, Incorporated, a California corporation, from AoA's existing shareholder. AoA manufacturers aviation armor both for helicopters and for fixed wing aircraft, marine armor, personnel armor, armoring kits for military vehicles, fragmentation blankest and a unique ballistic/flotation vest (ArmourFloat) that is U.S. Coast Guard-certified. The consideration for the purchase of AoA consisted of cash in the amount of $22,000,000, with additional possible earn-outs of up to $18,000,000 based on 2004 net pretax profit and on the receipt by AoA of certain specific and limited material contracts.

FUNCTIONAL CURRENCY

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

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



OVERVIEW OF OPERATING PERFORMANCE AND BACKLOG

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

In the first six months of 2004, IES experienced a substantial slowdown of new sales. As of June 30, 2004, our backlog for our Simulation, Training and Consulting Division totaled $8.6 million, most of which was attributable to FAAC.

In our Battery and Power Systems Division, EFB and Epsilor had revenues roughly in line with expectations. As of June 30, 2004, our backlog for our Battery and Power Systems Division totaled $7.7 million.

In our Armored Vehicle Division, MDT Armor experienced an increase in revenues during the first six months of 2004 as a result of new orders in connection with the War in Iraq. As of June 30, 2004, our backlog for our Armored Vehicle Division totaled $9.3 million.

RESULTS OF OPERATIONS

PRELIMINARY NOTE

Results for the three and six months ended June 30, 2004 include the results of FAAC and Epsilor for such period as a result of our acquisitions of these companies early in the first quarter of 2004. The results of FAAC and Epsilor were not included in our operating results for the three and six months ended June 30, 2003. Accordingly, the following period-to-period comparisons should not necessarily be relied upon as indications of future performance.

THREE MONTHS ENDED JUNE 30, 2004 COMPARED TO THE THREE MONTHS ENDED JUNE 30, 2003.

REVENUES. During the three months ended June 30, 2004, 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 warranty services in connection with such systems;

- MDT and MDT Armor recognized revenues from payments under vehicle armoring contracts and for service and repair of armored vehicles;

>> EFB and Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army; and

>> EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase IV of the United States Department of Transportation (DOT) electric bus program.





Revenues for the three months ended June 30, 2004 totaled $9.9 million, compared to $3.5 million in the comparable period in 2003, an increase of $6.4 million, or 184%. This increase was primarily attributable to the following factors:

>> Increased revenues from our Armored Vehicle Division, particularly MDT Armor; and

>> Revenues from FAAC and Epsilor present in the second quarter of 2004 that were not present in the corresponding period of 2003.

These revenues were offset to some extent by

>> Decreased CECOM revenues from our EFB subsidiary.

In the second quarter of 2004, revenues were $4.0 million for the Simulation, Training and Consulting Division (compared to $883,000 in the second quarter of 2003, an increase of $3.1 million, or 354%, due primarily to the added revenues of FAAC); $2.6 million for the Battery and Power Systems Division (compared to $2.0 million in the second quarter of 2003, an increase of $602,000, or 30%, due primarily to the added revenues of Epsilor, offset to some extent by decreased revenues from EFB); and $3.3 million for the Armored Vehicle Division (compared to $586,000 in the second quarter of 2003, an increase of $2.7 million, or 461%, due primarily to increased revenues from MDT Armor).

COST OF REVENUES AND GROSS PROFIT. Cost of revenues totaled $6.6 million during the second quarter of 2004, compared to $2.5 million in the second quarter of 2003, an increase of $4.1 million, or 165%, due primarily to increased sales in all divisions.

Direct expenses for our three divisions during the second quarter of 2004 were $3.8 million for the Simulation, Training and Consulting Division (compared to $1.3 million in the second quarter of 2003, an increase of $2.5 million, or 191%, due primarily the added expenses of FAAC ); $2.6 million for the Battery and Power Systems Division (compared to $1.8 million in the second quarter of 2003, an increase of $847,000, or 48%, due primarily to the added revenues of Epsilor ($1.3 million), offset to some extent by decreased revenues of our Zinc-Air military batteries); and $3.0 million for the Armored Vehicle Division (compared to $780,000 in the second quarter of 2003, an increase of $2.2 million, or 288%, due primarily to increased revenues from MDT Armor).

Gross profit was $3.4 million during the second quarter of 2004, compared to $1.0 million during the second quarter of 2003, an increase of $2.3 million, or 231%. This increase was the direct result of all factors presented above, most notably the presence of FAAC and Epsilor in our results and the increase in vehicle armoring revenues.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses for the second quarter of 2004 were $408,000, compared to $153,000 during the second quarter of 2003, an increase of $256,000, or 168%. This increase was primarily the result of the inclusion of the research and development expenses of FAAC and Epsilor in our results this quarter.





SALES AND MARKETING EXPENSES. Sales and marketing expenses for the second quarter of 2004 were $1.1 million, compared to $934,000 the second quarter of 2003, an increase of $186,000, or 20%. This increase was primarily attributable to the inclusion of the sales and marketing expenses of FAAC and Epsilor in our results for 2004. Those expenses were offset to some extent by a decrease in expenses related to our security consulting business in the U.S.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses for the second quarter of 2004 were $3.5 million compared to $1.5 million in the second quarter of 2003, an increase of $2.1 million, or 141%. This increase was primarily attributable to the following factors:

>> The inclusion of the general and administrative expenses of FAAC and Epsilor in our results for 2004;

>> Expenses in 2004 in connection with warrant repricings, grants of new warrants and grants of options and shares to Employees, in the amount of $574,000, that were not present in 2003;

>> Increases in other general and administrative expenses in comparison to 2003, such as employees accruals and expenses related to due diligence performed in connection to certain potential acquisitions; and

>> Expenses incurred in connection with new activities by our Arocon and MDT Armor subsidiaries.

FINANCIAL EXPENSES, NET. Financial expenses, net of interest income and exchange differentials, totaled approximately $2.0 million in the second quarter of 2004 compared to $726,000 in the second quarter of 2003, a difference of $1.3 million, or 174%. This difference was due primarily to amortization of compensation related to the issuance of convertible debentures, as well as interest expenses related to those debentures.

INCOME TAXES. We and certain of our subsidiaries incurred net operating losses during 2004 and, accordingly, we were not required to make any provision for income taxes. With respect to some of our subsidiaries that operated at a net profit during 2004, we were able to offset federal taxes against our losses carry forward. We recorded a total of $175,000 in tax expenses in the second quarter of 2004, with respect to certain of our subsidiaries that operated at a net profit during 2004 and we are not able to offset their taxes against our loss carry forward and with respect to state taxes. In the second quarter of 2003, tax expenses written were with respect to MDT's taxable income.

AMORTIZATION OF INTANGIBLE ASSETS. Amortization of intangible assets totaled $496,000 in the second quarter of 2004, compared to $312,000 the second quarter of 2003, an increase of $184,000, or 59%. $226,000 of this amortization was attributable to FAAC and $142,000 was attributable to Epsilor.

NET LOSS. Due to the factors cited above, we reported a net loss of $4.4 million in the second quarter of 2004, compared to a net loss of $2.5 million the second quarter of 2003, an increase of $1.9 million.



SIX MONTHS ENDED JUNE 30, 2004 COMPARED TO THE SIX MONTHS ENDED JUNE 30, 2003.

REVENUES. During the six months ended June 30, 2004, 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 warranty services in connection with such systems;

>> MDT and MDT Armor recognized revenues from payments under vehicle armoring contracts and for service and repair of armored vehicles;

>> EFB and Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army;

>> Arocon recognized revenues under consulting agreements; and

>> EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase IV of the United States Department of Transportation (DOT) electric bus program.

Revenues for the six months ended June 30, 2004 totaled $17.1 million, compared to $7.5 million in the comparable period in 2003, an increase of $9.6 million, or 127%. This increase was primarily attributable to the following factors:

>> Increased revenues from our Armored Vehicle Division, particularly MDT Armor;

>> Increased revenues from our Battery and Power Systems Division, particularly CECOM revenues from EFB; and

>> Revenues from FAAC and Epsilor present in the first half of 2004 that were not present in the corresponding period of 2003.

These revenues were offset to some extent by

>> Decreased revenues from our IES subsidiary.

In the first half of 2004, revenues were $7.2 million for the Simulation, Training and Consulting Division (compared to $2.8 million in the first half of 2003, an increase of $4.4 million, or 154%, due primarily to the added revenues of FAAC, offset to some extent by decreased revenues from IES); $5.1 million for the Battery and Power Systems Division (compared to $2.9 million in the first half of 2003, an increase of $2.3 million, or 80%, due primarily to increased sales of our Zinc-Air military batteries and the added revenues of Epsilor); and $4.8 million for the Armored Vehicle Division (compared to $1.8 million in the first half of 2003, an increase of $2.9 million, or 159%, due primarily to increased revenues from MDT Armor).

COST OF REVENUES AND GROSS PROFIT. Cost of revenues totaled $11.1 million during the first half of 2004, compared to $5.1 million in the first

half of 2003, an increase of $6.0 million, or 118%, due primarily to increased sales in all divisions.





Direct expenses for our three divisions during the first half of 2004 were $6.9 million for the Simulation, Training and Consulting Division (compared to $3.0 million in the first half of 2003, an increase of $3.9 million, or 130%, due primarily the added expenses of FAAC, offset to some extent by decreased sales by IES); $5.1 million for the Battery and Power Systems Division (compared to $2.8 million in the first half of 2003, an increase of $2.3 million, or 84%, due primarily to increased in sales of our Zinc-Air military batteries and the added revenues of Epsilor ($2.0 million); and $4.4 million for the Armored Vehicle Division (compared to $1.9 million in the first half of 2003, an increase of $2.5 million, or 128%, due primarily to increased revenues from MDT Armor).

Gross profit was $6.0 million during the first half of 2004, compared to $2.4 million during the first half of 2003, an increase of $3.6 million, or 148%. This increase was the direct result of all factors presented above, most notably the presence of FAAC and Epsilor in our results and the increase in vehicle armoring revenues.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses for the first half of 2004 were $872,000, compared to $511,000 during the first half of 2003, an increase of $361,000, or 71%. This increase was the result of the inclusion of the research and development expenses of FAAC and Epsilor in our results this half.

SALES AND MARKETING EXPENSES. Sales and marketing expenses for the first half of 2004 were $2.1 million, compared to $1.6 million the first half of 2003, an increase of $503,000, or 31%. This increase was primarily attributable to the inclusion of the sales and marketing expenses of FAAC and Epsilor in our results for 2004

Those expenses were offset to some extent by decrease in expenses related to our security consulting business in the U.S. and decrease in expenses related to our military batteries field.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses for the first half of 2004 were $7.2 million compared to $2.5 million in the first half of 2003, an increase of $4.7 million, or 191%. This increase was primarily attributable to the following factors:

- >> The inclusion of the general and administrative expenses of FAAC and Epsilor in our results for 2004;
- >> Expenses in 2004 in connection with warrant repricings, grants of new warrants and grant of options and shares to employees in the amount of $2.2 million, that were not present in 2003; and
- >> Increases in other general and administrative expenses in comparison to 2003, such as employee accruals, amortization of certain expenses related to convertible debentures, and expenses related to due diligence performed in connection to certain potential acquisitions; and
- >> We incurred expenses in connection with new activities by our Arocon and MDT Armor subsidiaries.





FINANCIAL EXPENSES, NET. Financial expenses, net of interest income and exchange differentials, totaled approximately $3.3 million in the first half of 2004 compared to $984,000 in the first half of 2003, a difference of $2.3 million or 231%. This difference was due primarily to amortization of compensation related to the issuance of convertible debentures, as well as interest expenses related to those debentures.

INCOME TAXES. We and certain of our subsidiaries incurred net operating losses during 2004 and, accordingly, we were not required to make any provision for income taxes. With respect to some of our subsidiaries that operated at a net profit during 2004, we were able to offset federal taxes against our losses carry forward. We recorded a total of $170,000 in tax expenses in the first half of 2004, with respect to certain of our subsidiaries that operated at a net profit during 2004 and we are not able to offset their taxes against our loss carry forward and with respect to state taxes. In the first half of 2003, tax expenses were written with respect to MDT's taxable income.

AMORTIZATION OF INTANGIBLE ASSETS. Amortization of intangible assets totaled $1 million in the first half of 2004, compared to $624,000 in the first half of 2003, an increase of $368,000, or 59%. $452,000 of this amortization was attributable to FAAC and $284,000 was attributable to Epsilor.

NET LOSS. Due to the factors cited above, we reported a net loss of $8.7 million in the first half of 2004, compared to a net loss of $3.8 million the first half of 2003, an increase of $4.8 million.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2004, we had $5.1 million in cash, $8.9 million in restricted collateral securities and cash deposits due within one year, $2.0 million in long-term restricted securities and deposits, and $127,000 in marketable securities, as compared to at December 31, 2003, when we had $13.7 million in cash and $706,000 in restricted cash deposits due within one year. The decrease in cash was primarily the result of the costs of the acquisitions of FAAC and Epsilor, and working capital needed in our other segments.

We used available funds in the first six months of 2004 primarily for acquisitions, sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets during the six months ended June 30, 2004 by $637,000 over the investment as at December 31, 2003, primarily in the Battery and Power Systems Division and in the Simulation, Training and Consulting Division. Our net fixed assets amounted to $3.3 million at quarter end.

Net cash used in operating activities from continuing operations for the six months ended June 30, 2004 and 2003 was $1.1 million and $2.5 million, respectively, a decrease of $1.4 million. This decrease was primarily the result of changes in operating assets and liabilities, particularly an increase in deferred revenues and decrease in trade receivables.

Net cash used in investing activities for the six months ended June 30, 2004 and 2003 was $29.9 million and $520,000, respectively, an increase of $29.4 million. This increase was primarily the result of our investment in the acquisition of FAAC and Epsilor in 2004.



Net cash provided by financing activities for the six months ended June 30, 2004 and 2003 was $22.5 million and $4.5 million, respectively, an increase of $18.1 million, or 404%. This increase was primarily the result of higher amounts of funds raised through sales of our securities in 2004 compared to 2003.

During the six months ended June 30, 2004, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately $1.1 million.

As of June 30, 2004, we had (based on the contractual amount of the debt and not on the accounting valuation of the debt) approximately $7.4 million in long term bank and certificated debt outstanding, of which $5.3 million was convertible debt, and approximately $1.4 million in short-term debt.

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

Based on our internal forecasts, we believe that our present cash position and anticipated cash flows from operations should be sufficient to satisfy our current estimated cash requirements through the next year. This belief is based on certain assumptions that our management believes to be reasonable, some of which are subject to the risk factors detailed below. 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.

## RISK FACTORS

The following factors, among others, could cause actual results to differ materially from those contained in forward-looking statements made in this Report and presented elsewhere by management from time to time.

BUSINESS-RELATED RISKS

WE HAVE HAD A HISTORY OF LOSSES AND MAY INCUR FUTURE LOSSES.

We were incorporated in 1990 and began our operations in 1991. We have funded our operations principally from funds raised in each of the initial public offering of our common stock in February 1994; through subsequent public and private offerings of our common stock and equity and debt securities convertible into shares of our common stock; research contracts and supply contracts; funds received under research and development grants from the Government of Israel; and sales of products that we and our subsidiaries manufacture. We have incurred significant operating losses since our inception. Additionally, as of June 30, 2004, we had an accumulated deficit of approximately $118.4 million. There can be no assurance that we will ever be able to maintain profitability consistently or that our business will continue to exist.

OUR EXISTING INDEBTEDNESS MAY ADVERSELY AFFECT OUR ABILITY TO OBTAIN ADDITIONAL FUNDS AND MAY INCREASE OUR VULNERABILITY TO ECONOMIC OR BUSINESS DOWNTURNS.

Our bank and certificated indebtedness aggregated approximately $8.9 million as of June 30, 2004. Accordingly, we are subject to the risks associated with indebtedness, including:

- we must dedicate a portion of our cash flows from operations to pay debt service costs and, as a result, we have less funds available for operations, future acquisitions of consumer receivable portfolios, and other purposes;
- it may be more difficult and expensive to obtain additional funds through financings, if available at all;
- we are more vulnerable to economic downturns and fluctuations in interest rates, less able to withstand competitive pressures and less flexible in reacting to changes in our industry and general economic conditions; and
- if we default under any of our existing debt instruments or if our creditors demand payment of a portion or all of our indebtedness, we may not have sufficient funds to make such payments.

The occurrence of any of these events could materially adversely affect our results of operations and financial condition and adversely affect our stock price.

The agreements governing the terms of our debentures contain numerous affirmative and negative covenants that limit the discretion of our management with respect to certain business matters and place restrictions on us, including obligations on our part to preserve and maintain our assets and restrictions on our ability to incur or guarantee debt, to merge with or sell our assets to another company, and to make significant capital expenditures without the consent of the debenture holders. Our ability to comply with these and other provisions of such agreements may be affected by changes in economic or business conditions or other events beyond our control.

FAILURE TO COMPLY WITH THE TERMS OF OUR DEBENTURES COULD RESULT IN A DEFAULT THAT COULD HAVE MATERIAL ADVERSE CONSEQUENCES FOR US.

A failure to comply with the obligations contained in our debenture agreements could result in an event of default under such agreements which could result in an acceleration of the debentures and the acceleration of debt under other instruments evidencing indebtedness that may contain cross-acceleration or cross-default provisions. If the indebtedness under the debentures or other indebtedness were to be accelerated, there can be no assurance that our assets would be sufficient to repay in full such indebtedness.

WE HAVE PLEDGED A SUBSTANTIAL PORTION OF OUR ASSETS TO SECURE OUR BORROWINGS.

Our debentures are secured by a substantial portion of our assets. If we default under the indebtedness secured by our assets, those assets would be available to the secured creditors to satisfy our obligations to the secured creditors, which could materially adversely affect our results of operations and financial condition and adversely affect our stock price.



WE NEED SIGNIFICANT AMOUNTS OF CAPITAL TO OPERATE AND GROW OUR BUSINESS.

We require substantial funds to market our products and develop and market new products. To the extent that we are unable to fully fund our operations through profitable sales of our products and services, we may continue to seek additional funding, including through the issuance of equity or debt securities. However, there can be no assurance that we will obtain any such additional financing in a timely manner or on acceptable terms. If additional funds are raised by issuing equity securities, stockholders may incur further dilution. If additional funding is not secured, we will have to modify, reduce, defer or eliminate parts of our anticipated future commitments and/or programs.

WE MAY NOT BE SUCCESSFUL IN OPERATING A NEW BUSINESS.

Prior to the acquisitions of IES and MDT in 2002 and the acquisitions of FAAC and Epsilor in January 2004 and AoA in August 2004, our primary business was the marketing and sale of products based on primary and refuelable Zinc-Air fuel cell technology and advancements in battery technology for defense and security products and other military applications, electric vehicles and consumer electronics. As a result of our acquisitions, a substantial component

of our business is the marketing and sale of hi-tech multimedia and interactive training solutions and sophisticated lightweight materials and advanced engineering processes used to armor vehicles. These are new businesses for us and our management group has limited experience operating these types of businesses. Although we have retained our acquired companies' management personnel, we cannot assure that such personnel will continue to work for us or that we will be successful in managing this new business. If we are unable to successfully operate these new businesses, our business, financial condition and results of operations could be materially impaired.

OUR ACQUISITION STRATEGY INVOLVES VARIOUS RISKS.

Part of our strategy is to grow through the acquisition of companies that will complement our existing operations or provide us with an entry into markets we do not currently serve. Growth through acquisitions involves substantial risks, including the risk of improper valuation of the acquired business and the risk of inadequate integration. There can be no assurance that suitable acquisition candidates will be available, that we will be able to acquire or manage profitably such additional companies or that future acquisitions will produce returns that justify our investments therein. In addition, we may compete for acquisition and expansion opportunities with companies that have significantly greater resources than we do. Furthermore, acquisitions could disrupt our ongoing business, distract the attention of our senior managers, make it difficult to maintain our operational standards, controls and procedures and subject us to contingent and latent risks that are different, in nature and magnitude, than the risks we currently face.

We may finance future acquisitions with cash from operations or additional debt or equity financings. There can be no assurance that we will be able to generate internal cash or obtain financing from external sources or that, if available, such financing will be on terms acceptable to us. The issuance of additional common stock to finance acquisitions may result in substantial dilution to our stockholders. Any debt financing may significantly increase our leverage and may involve restrictive covenants which limit our operations.





WE MAY NOT SUCCESSFULLY INTEGRATE OUR NEW ACQUISITIONS.

In light of our recent acquisitions of IES, MDT, FAAC, Epsilor and AoA, our success will depend in part on our ability to manage the combined operations of these companies and to integrate the operations and personnel of these companies along with our other subsidiaries and divisions into a single organizational structure. There can be no assurance that we will be able to effectively integrate the operations of our subsidiaries and divisions and our newly-acquired businesses into a single organizational structure. Integration of these operations could also place additional pressures on our management as well as on our key technical resources. The failure to successfully manage this integration could have an adverse material effect on us.

If we are successful in acquiring additional businesses, we may experience a period of rapid growth that could place significant additional demands on, and require us to expand, our management, resources and management information systems. Our failure to manage any such rapid growth effectively could have a material adverse effect on our financial condition, results of operations and cash flows.

IF WE ARE UNABLE TO MANAGE OUR GROWTH, OUR OPERATING RESULTS WILL BE IMPAIRED.

We are currently experiencing a period of growth and development activity which could place a significant strain on our personnel and resources. Our activity has resulted in increased levels of responsibility for both existing and new management personnel. Many of our management personnel have had limited or no experience in managing growing companies. We have sought to manage our current and anticipated growth through the recruitment of additional management and technical personnel and the implementation of internal systems and controls. However, our failure to manage growth effectively could adversely affect our results of operations.

A SIGNIFICANT PORTION OF OUR BUSINESS IS DEPENDENT ON GOVERNMENT CONTRACTS.

Many of the customers of IES, FAAC and AoA to date have been in the public sector of the U.S., including the federal, state and local governments, and in the public sectors of a number of other countries, and most of MDT's customers have been in the public sector in Israel, in particular the Ministry of Defense. Additionally, all of EFB's sales to date of battery products for the military and defense sectors have been in the public sector in the United States. A significant decrease in the overall level or allocation of defense spending or law enforcement in the U.S. or other countries could have a material adverse effect on our future results of operations and financial condition. MDT has already experienced a slowdown in orders from the Ministry of Defense due to budget constraints and a requirement of U.S. aid to Israel that a substantial proportion of such aid be spent in the U.S., where MDT has only recently opened a factory in operation.

Sales to public sector customers are subject to a multiplicity of

detailed regulatory requirements and public policies as well as to changes in training and purchasing priorities. Contracts with public sector customers may be conditioned upon the continuing availability of public funds, which in turn depends upon lengthy and complex budgetary procedures, and may be subject to certain pricing constraints. Moreover, U.S. government contracts and those of many international government customers may generally be terminated for a variety of factors when it is in the best interests of the government and contractors may be suspended or debarred for misconduct at the discretion of the



government. There can be no assurance that these factors or others unique to government contracts or the loss or suspension of necessary regulatory licenses will not have a material adverse effect on our future results of operations and financial condition.

OUR U.S. GOVERNMENT CONTRACTS MAY BE TERMINATED AT ANY TIME AND MAY CONTAIN OTHER UNFAVORABLE PROVISIONS.

The U.S. government typically can terminate or modify any of its contracts with us either for its convenience or if we default by failing to perform under the terms of the applicable contract. A termination arising out of our default could expose us to liability and have a material adverse effect on our ability to re-compete for future contracts and orders. Our U.S. government contracts contain provisions that allow the U.S. government to unilaterally suspend us from receiving new contracts pending resolution of alleged violations of procurement laws or regulations, reduce the value of existing contracts, issue modifications to a contract and control and potentially prohibit the export of our products, services and associated materials.

A negative audit by the U.S. government could adversely affect our business, and we might not be reimbursed by the government for costs that we have expended on our contracts.

Government agencies routinely audit government contracts. These agencies review a contractor's performance on its contract, pricing practices, cost structure and compliance with applicable laws, regulations and standards. If we are audited, we will not be reimbursed for any costs found to be improperly allocated to a specific contract, while we would be required to refund any improper costs for which we had already been reimbursed. Therefore, an audit could result in a substantial adjustment to our revenues. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeitures of profits, suspension of payments, fines and suspension or debarment from doing business with United States government agencies. We could suffer serious reputational harm if allegations of impropriety were made against us. A governmental determination of impropriety or illegality, or an allegation of impropriety, could have a material adverse effect on our business, financial condition or results of operations.

WE MAY BE LIABLE FOR PENALTIES UNDER A VARIETY OF PROCUREMENT RULES AND REGULATIONS, AND CHANGES IN GOVERNMENT REGULATIONS COULD ADVERSELY IMPACT OUR REVENUES, OPERATING EXPENSES AND PROFITABILITY.

Our defense and commercial businesses must comply with and are affected by various government regulations that impact our operating costs, profit margins and our internal organization and operation of our businesses. Among the most significant regulations are the following:

- the U.S. Federal Acquisition Regulations, which regulate the formation, administration and performance of government contracts;
- the U.S. Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations; and



- the U.S. Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under certain cost-based government contracts.

These regulations affect how we and our customers do business and, in some instances, impose added costs on our businesses. Any changes in applicable laws could adversely affect the financial performance of the business affected by the changed regulations. With respect to U.S. government contracts, any failure to comply with applicable laws could result in contract termination, price or fee reductions or suspension or debarment from contracting with the U.S. government.

OUR OPERATING MARGINS MAY DECLINE UNDER OUR FIXED-PRICE CONTRACTS IF WE FAIL TO ESTIMATE ACCURATELY THE TIME AND RESOURCES NECESSARY TO SATISFY OUR OBLIGATIONS.

Some of our contracts are fixed-price contracts under which we bear the risk of any cost overruns. Our profits are adversely affected if our costs under these contracts exceed the assumptions that we used in bidding for the contract. In the six months ended June 30, 2004, approximately 24% of our revenues were derived from fixed-price contracts for both defense and non-defense related government contracts. Often, we are required to fix the price for a contract before we finalize the project specifications, which increases the risk that we will mis-price these contracts. The complexity of many of our engagements makes accurately estimating our time and resources more difficult.

IF WE ARE UNABLE TO RETAIN OUR CONTRACTS WITH THE U.S. GOVERNMENT AND SUBCONTRACTS UNDER U.S. GOVERNMENT PRIME CONTRACTS IN THE COMPETITIVE REBIDDING PROCESS, OUR REVENUES MAY SUFFER.

Upon expiration of a U.S. government contract or subcontract under a U.S. government prime contract, if the government customer requires further services of the type provided in the contract, there is frequently a competitive rebidding process. We cannot guarantee that we, or if we are a subcontractor that the prime contractor, will win any particular bid, or that we will be able to replace business lost upon expiration or completion of a contract. Further, all U.S. government contracts are subject to protest by competitors. The termination of several of our significant contracts or nonrenewal of several of our significant contracts could result in significant revenue shortfalls.

SOME OF THE COMPONENTS OF OUR PRODUCTS POSE POTENTIAL SAFETY RISKS WHICH COULD CREATE POTENTIAL LIABILITY EXPOSURE FOR US.

Some of the components of our products contain elements that are known to pose potential safety risks. In addition to these risks, and there can be no assurance that accidents in our facilities will not occur. Any accident, whether occasioned by the use of all or any part of our products or technology or by our manufacturing operations, could adversely affect commercial acceptance of our products and could result in significant production delays or claims for damages resulting from injuries. Any of these occurrences would materially adversely affect our operations and financial condition.



WE MAY FACE PRODUCT LIABILITY CLAIMS.

In the event that our products, including the products manufactured by MDT, fail to perform as specified, users of these products may assert claims for substantial amounts. These claims could have a materially adverse effect on our financial condition and results of operations. There is no assurance that the amount of the general product liability insurance that we maintain will be sufficient to cover potential claims or that the present amount of insurance can be maintained at the present level of cost, or at all.

OUR FIELDS OF BUSINESS ARE HIGHLY COMPETITIVE.

The competition to develop defense and security products and electric vehicle battery systems, and to obtain funding for the development of these products, is, and is expected to remain, intense.

Our defense and security products compete with other manufacturers of specialized training systems, including Firearms Training Systems, Inc., a producer of interactive simulation systems designed to provide training in the handling and use of small and supporting arms. In addition, we compete with manufacturers and developers of armor for cars and vans, including O'Gara-Hess & Eisenhardt, a division of Armor Holdings, Inc.

Our battery technology competes with other battery technologies, as well as other Zinc-Air technologies. The competition in this area of our business consists of development stage companies, major international companies and consortia of such companies, including battery manufacturers, automobile manufacturers, energy production and transportation companies, consumer goods companies and defense contractors. Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

Various battery technologies are being considered for use in electric vehicles and defense and safety products by other manufacturers and developers, including the following: lead-acid, nickel-cadmium, nickel-iron, nickel-zinc, nickel-metal hydride, sodium-sulfur, sodium-nickel chloride, zinc-bromine, lithium-ion, lithium-polymer, lithium-iron sulfide, primary lithium, rechargeable alkaline and Zinc-Air.

If we are unable to compete successfully in each of our operating areas, especially in the defense and security products area of our business, our business and results of operations could be materially adversely affected.

OUR BUSINESS IS DEPENDENT ON PROPRIETARY RIGHTS THAT MAY BE DIFFICULT TO PROTECT AND COULD AFFECT OUR ABILITY TO COMPETE EFFECTIVELY.

Our ability to compete effectively will depend on our ability to maintain the proprietary nature of our technology and manufacturing processes through a combination of patent and trade secret protection, non-disclosure agreements and licensing arrangements.

Litigation, or participation in administrative proceedings, may be necessary to protect our proprietary rights. This type of litigation can be costly and time consuming and could divert company resources and management





attention to defend our rights, and this could harm us even if we were to be successful in the litigation. In the absence of patent protection, and despite our reliance upon our proprietary confidential information, our competitors may be able to use innovations similar to those used by us to design and manufacture products directly competitive with our products. In addition, no assurance can be given that others will not obtain patents that we will need to license or design around. To the extent any of our products are covered by third-party patents, we could need to acquire a license under such patents to develop and market our products.

Despite our efforts to safeguard and maintain our proprietary rights, we may not be successful in doing so. In addition, competition is intense, and there can be no assurance that our competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technology. Moreover, in the event of patent litigation, we cannot assure you that a court would determine that we were the first creator of inventions covered by our issued patents or pending patent applications or that we were the first to file patent applications for those inventions. If existing or future third-party patents containing broad claims were upheld by the courts or if we were found to infringe third party patents, we may not be able to obtain the required licenses from the holders of such patents on acceptable terms, if at all. Failure to obtain these licenses could cause delays in the introduction of our products or necessitate costly attempts to design around such patents, or could foreclose the development, manufacture or sale of our products. We could also incur substantial costs in defending ourselves in patent infringement suits brought by others and in prosecuting patent infringement suits against infringers.

We also rely on trade secrets and proprietary know-how that we seek to protect, in part, through non-disclosure and confidentiality agreements with our customers, employees, consultants, and entities with which we maintain strategic relationships. We cannot assure you that these agreements will not be breached, that we would have adequate remedies for any breach or that our trade secrets will not otherwise become known or be independently developed by competitors.

WE ARE DEPENDENT ON KEY PERSONNEL AND OUR BUSINESS WOULD SUFFER IF WE FAIL TO RETAIN THEM.

We are highly dependent on the presidents of our IES, FAAC and AoA subsidiaries and the general managers of our MDT and Epsilor subsidiaries, and the loss of the services of one or more of these persons could adversely affect us. We are especially dependent on the services of our Chairman, President and Chief Executive Officer, Robert S. Ehrlich. The loss of Mr. Ehrlich could have a material adverse effect on us. We are party to an employment agreement with Mr. Ehrlich, which agreement expires at the end of 2005. We do not have key-man life insurance on Mr. Ehrlich.

THERE ARE RISKS INVOLVED WITH THE INTERNATIONAL NATURE OF OUR BUSINESS.

A significant portion of our sales are made to customers located outside the U.S., primarily in Europe and Asia. In 2003, 2002 and 2001, without taking account of revenues derived from discontinued operations, 42%, 56% and 49%, respectively, of our revenues, were derived from sales to customers located outside the U.S. We expect that our international customers will continue to account for a substantial portion of our revenues in the near future. Sales to





international customers may be subject to political and economic risks, including political instability, currency controls, exchange rate fluctuations, foreign taxes, longer payment cycles and changes in import/export regulations and tariff rates. In addition, various forms of protectionist trade legislation have been and in the future may be proposed in the U.S. and certain other countries. Any resulting changes in current tariff structures or other trade and monetary policies could adversely affect our sales to international customers.

INVESTORS SHOULD NOT PURCHASE OUR COMMON STOCK WITH THE EXPECTATION OF RECEIVING CASH DIVIDENDS.

We currently intend to retain any future earnings for funding growth and, as a result, do not expect to pay any cash dividends in the foreseeable future.

MARKET-RELATED RISKS

THE PRICE OF OUR COMMON STOCK IS VOLATILE.

The market price of our common stock has been volatile in the past and may change rapidly in the future. The following factors, among others, may cause significant volatility in our stock price:

- Announcements by us, our competitors or our customers;
- The introduction of new or enhanced products and services by us or our competitors;
- Changes in the perceived ability to commercialize our technology compared to that of our competitors;
- Rumors relating to our competitors or us;
- Actual or anticipated fluctuations in our operating results; and
- General market or economic conditions.

IF OUR SHARES WERE TO BE DELISTED, OUR STOCK PRICE MIGHT DECLINE FURTHER AND WE MIGHT BE UNABLE TO RAISE ADDITIONAL CAPITAL.

One of the continued listing standards for our stock on the Nasdaq National Market is the maintenance of a $1.00 bid price. Our stock price has periodically traded below $1.00 in the recent past. If our bid price were to go and remain below $1.00 for 30 consecutive business days, Nasdaq could notify us of our failure to meet the continued listing standards, after which we would have 180 calendar days to correct such failure or be delisted from the Nasdaq National Market.

Although we would have the opportunity to appeal any potential delisting, there can be no assurances that this appeal would be resolved favorably. As a result, there can be no assurance that our common stock will remain listed on the Nasdaq National Market. If our common stock were to be delisted from the Nasdaq National Market, we might apply to be listed on the Nasdaq SmallCap market; however, there can be no assurance that we would be approved for listing on the Nasdaq SmallCap market, which has the same $1.00 minimum bid and other similar requirements as the Nasdaq National Market. If we



were to move to the Nasdaq SmallCap market, current Nasdaq regulations would give us the opportunity to obtain an additional 180-day grace period and an additional 90-day grace period after that if we meet certain net income, stockholders' equity or market capitalization criteria. While our stock would continue to trade on the over-the-counter bulletin board following any delisting from the Nasdaq, any such delisting of our common stock could have an adverse effect on the market price of, and the efficiency of the trading market for, our common stock. Also, if in the future we were to determine that we need to seek additional equity capital, it could have an adverse effect on our ability to raise capital in the public equity markets.

In addition, if we fail to maintain Nasdaq listing for our securities, and no other exclusion from the definition of a "penny stock" under the Securities Exchange Act of 1934, as amended, is available, then any broker engaging in a transaction in our securities would be required to provide any customer with a risk disclosure document, disclosure of market quotations, if any, disclosure of the compensation of the broker-dealer and its salesperson in the transaction and monthly account statements showing the market values of our securities held in the customer's account. The bid and offer quotation and compensation information must be provided prior to effecting the transaction and must be contained on the customer's confirmation. If brokers become subject to the "penny stock" rules when engaging in transactions in our securities, they would become less willing to engage in transactions, thereby making it more difficult for our stockholders to dispose of their shares.

A SUBSTANTIAL NUMBER OF OUR SHARES ARE AVAILABLE FOR SALE IN THE PUBLIC MARKET AND SALES OF THOSE SHARES COULD ADVERSELY AFFECT OUR STOCK PRICE.

Sales of a substantial number of shares of common stock into the public market, or the perception that those sales could occur, could adversely affect our stock price or could impair our ability to obtain capital through an offering of equity securities. As of August 10, 2004, we had 79,078,483 shares of common stock issued and outstanding. Of these shares, most are freely transferable without restriction under the Securities Act of 1933, and a substantial portion of the remaining shares may be sold subject to the volume restrictions, manner-of-sale provisions and other conditions of Rule 144 under the Securities Act of 1933.

In connection with a stock purchase agreement dated September 30, 1996 between Leon S. Gross and us, we also entered into a registration rights agreement with Mr. Gross dated September 30, 1996, providing registration rights with respect to the shares of common stock issued to Mr. Gross in connection with the offering. These rights include the right to make two demands for the registration of the shares of our common stock owned by Mr. Gross. In addition, Mr. Gross was granted unlimited rights to "piggyback" on registration statements that we file for the sale of our common stock. Mr. Gross presently owns 3,482,534 shares, of which 1,538,462 have never been registered.

EXERCISE OF OUR WARRANTS, OPTIONS AND CONVERTIBLE DEBT COULD ADVERSELY AFFECT OUR STOCK PRICE AND WILL BE DILUTIVE.

As of August 10, 2004, there were outstanding warrants to purchase a total of 18,183,513 shares of our common stock at a weighted average exercise price of $1.58 per share, options to purchase a total of 8,996,880 shares of our



common stock at a weighted average exercise price of $1.32 per share, of which 5,706,463 were vested, at a weighted average exercise price of $1.48 per share, and outstanding debentures convertible into a total of 3,786,732 shares of our common stock at a weighted average conversion price of $1.39 per share. Holders of our options, warrants and convertible debt will probably exercise or convert them only at a time when the price of our common stock is higher than their respective exercise or conversion prices. Accordingly, we may be required to issue shares of our common stock at a price substantially lower than the market price of our stock. This could adversely affect our stock price. In addition, if and when these shares are issued, the percentage of our common stock that existing stockholders own will be diluted.

OUR CERTIFICATE OF INCORPORATION AND BYLAWS AND DELAWARE LAW CONTAIN PROVISIONS THAT COULD DISCOURAGE A TAKEOVER.

Provisions of our amended and restated certificate of incorporation may have the effect of making it more difficult for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. These provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock. These provisions:

- divide our board of directors into three classes serving staggered three-year terms;
- only permit removal of directors by stockholders "for cause," and require the affirmative vote of at least 85% of the outstanding common stock to so remove; and
- allow us to issue preferred stock without any vote or further action by the stockholders.

The classification system of electing directors and the removal provision may tend to discourage a third-party from making a tender offer or otherwise attempting to obtain control of us and may maintain the incumbency of our board of directors, as the classification of the board of directors increases the difficulty of replacing a majority of the directors. These provisions may have the effect of deferring hostile takeovers, delaying changes in our control or management, or may make it more difficult for stockholders to take certain corporate actions. The amendment of any of these provisions would require approval by holders of at least 85% of the outstanding common stock.

ISRAEL-RELATED RISKS

A SIGNIFICANT PORTION OF OUR OPERATIONS TAKES PLACE IN ISRAEL, AND WE COULD BE ADVERSELY AFFECTED BY THE ECONOMIC, POLITICAL AND MILITARY CONDITIONS IN THAT REGION.

The offices and facilities of three of our subsidiaries, EFL, MDT and Epsilor, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of our senior management is located at EFL's facilities. Although we expect that most of our sales will be made to customers outside Israel, we are nonetheless directly affected by economic, political and military conditions in that country. Accordingly, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have





a material adverse effect on our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel.

Historically, Arab states have boycotted any direct trade with Israel and to varying degrees have imposed a secondary boycott on any company carrying on trade with or doing business in Israel. Although in October 1994, the states comprising the Gulf Cooperation Council (Saudi Arabia, the United Arab Emirates, Kuwait, Dubai, Bahrain and Oman) announced that they would no longer adhere to the secondary boycott against Israel, and Israel has entered into certain agreements with Egypt, Jordan, the Palestine Liberation Organization and the Palestinian Authority, Israel has not entered into any peace arrangement with Syria or Lebanon. Moreover, since September 2000, there has been a significant deterioration in Israel's relationship with the Palestinian Authority, and a significant increase in terror and violence. Efforts to resolve the problem have failed to result in an agreeable solution. Continued hostilities between the Palestinian community and Israel and any failure to settle the conflict may have a material adverse effect on our business and us. Moreover, the current political and security situation in the region has already had an adverse effect

on the economy of Israel, which in turn may have an adverse effect on us.

SERVICE OF PROCESS AND ENFORCEMENT OF CIVIL LIABILITIES ON US AND OUR OFFICERS MAY BE DIFFICULT TO OBTAIN.

We are organized under the laws of the State of Delaware and will be subject to service of process in the United States. However, approximately 35% of our assets are located outside the United States. In addition, two of our directors and all of our executive officers are residents of Israel and a portion of the assets of such directors and executive officers are located outside the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, in original actions instituted in Israel. As a result, it may not be possible for investors to enforce or effect service of process upon these directors and executive officers or to judgments of U.S. courts predicated upon the civil liability provisions of U.S. laws against our assets, as well as the assets of these directors and executive officers. In addition, awards of punitive damages in actions brought in the U.S. or elsewhere may be unenforceable in Israel.

EXCHANGE RATE FLUCTUATIONS BETWEEN THE U.S. DOLLAR AND THE ISRAELI NIS MAY NEGATIVELY AFFECT OUR EARNINGS.

Although a substantial majority of our revenues and a substantial portion of our expenses are denominated in U.S. dollars, a portion of our costs, including personnel and facilities-related expenses, is incurred in New Israeli Shekels (NIS). Inflation in Israel will have the effect of increasing the dollar cost of our operations in Israel, unless it is offset on a timely basis by a devaluation of the NIS relative to the dollar. In 2003, the inflation adjusted NIS appreciated against the dollar, which raised the dollar cost of our Israeli operations.



SOME OF OUR AGREEMENTS ARE GOVERNED BY ISRAELI LAW.

Israeli law governs some of our agreements, such as our lease agreements on our subsidiaries' premises in Israel, and the agreements pursuant to which we purchased IES, MDT and Epsilor. While Israeli law differs in certain respects from American law, we do not believe that these differences materially adversely affect our rights or remedies under these agreements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

INTEREST RATE RISK

It is our policy not to enter into interest rate derivative financial instruments, except for hedging of foreign currency exposures discussed below. We do not currently have any significant interest rate exposure.

FOREIGN CURRENCY EXCHANGE RATE RISK

Since a significant part of our sales and expenses are denominated in U.S. dollars, we have experienced only insignificant foreign exchange gains and losses to date, and do not expect to incur significant gains and losses in 2004. Our research, development and production activities are primarily carried out by our Israeli subsidiary, EFL, at its facility in Beit Shemesh, and accordingly we have sales and expenses in NIS. Additionally, our MDT and Epsilor subsidiaries operate primarily in NIS. However, the majority of our sales are made outside Israel in U.S. dollars, and a substantial portion of our costs are incurred in U.S. dollars. Therefore, our functional currency is the U.S. dollar.

While we conduct our business primarily in U.S. dollars, some of our agreements are denominated in foreign currencies, and we occasionally hedge part of the risk of a devaluation of the U.S dollar, which could have an adverse effect on the revenues that we incur in foreign currencies. We do not hold or issue derivative financial instruments for trading or speculative purposes

ITEM 4. CONTROLS AND PROCEDURES.

As of the end of the second quarter of 2004, our management, including the principal executive officer and principal financial officer, evaluated the effectiveness of our disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in our periodic reports that we file with the SEC. These disclosure controls and procedures have been designed to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers, by other of our employees, and that this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Our controls and procedures can only provide reasonable, not absolute,

assurance that the above objectives have been met.





As of June 30, 2004, based upon their evaluations, these officers concluded that the design of the disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the SEC's rules and forms. We intend to continually strive to improve our disclosure controls and procedures to enhance the quality of our financial reporting.

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





## PART II

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

Issuance of Shares to an Employee

In June 2004, we issued at par value a total of 40,000 shares of our stock to the general manager of one of our subsidiaries, as a special stock bonus.

We issued the above securities in reliance on the exemption from registration provided by Section 4(2) of the Securities Act as transactions by an issuer not involving a public offering. The issuance of these securities was without the use of an underwriter, and the shares of common stock currently bear restrictive legends permitting transfer thereof only upon registration or an exemption under the Act.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

We held our 2004 Annual Meeting of Stockholders on June 14, 2004. At that meeting, the stockholders voted on the following matters with the following results:

1. Fixing the number of Class III Directors at three:

<TABLE>
<CAPTION>

| | VOTES FOR | VOTES AGAINST | ABSTENTIONS | SHARES NOT VOTING |
|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> |
| | 61,775,312 | 685,128 | 0 | 0 |

</TABLE>

2. Election of Class III Directors:

<TABLE>
<CAPTION>

| | VOTES FOR | VOTES AGAINST | ABSTENTIONS | SHARES NOT VOTING |
|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> |
| Robert S. Ehrlich..... | 61,775,312 | 0 | 0 | 0 |
| Bert W. Wasserman..... | 61,898,587 | 0 | 0 | 0 |
| Edward J. Borey..... | 61,934,783 | 0 | 0 | 0 |

(Directors whose terms of office continued after the meeting were Dr. Jay M. Eastman, Jack Rosenfeld, Lawrence M. Miller, and Steven Esses)

</TABLE>

3. Ratifying the appointment of Kost, Forer, Gabbay & Kassierer, a member of Ernst & Young Global, as the Company's independent accountants for the fiscal year ending December 31, 2004:

<TABLE>
<CAPTION>

| | VOTES FOR | VOTES AGAINST | ABSTENTIONS | SHARES NOT VOTING |
|---|---|---|---|---|
| <S> | <C> | <C> | <C> | <C> |
| | 61,790,881 | 518,508 | 151,050 | 0 |

</TABLE>

4. Amending the terms of the Company's Amended and Restated Certificate of Incorporation to increase the authorized common stock from 100,000,000 shares to 250,000,000 share:

<TABLE>
<CAPTION>

| VOTES FOR | VOTES AGAINST | ABSTENTIONS | SHARES NOT VOTING |
|---|---|---|---|
| <C> | <C> | <C> | <C> |
| 57,154,004 | 4,779,998 | 526,438 | 0 |

</TABLE>

5. Amending the terms of the Company's Amended and Restated 1995 Non-Employee Director Stock Option Plan to increase initial grants to from 25,000 to 50,000 options and annual grants from 10,000 to 35,000 options:

<TABLE>
<CAPTION>

| VOTES FOR | VOTES AGAINST | ABSTENTIONS | SHARES NOT VOTING |
|---|---|---|---|
| <C> | <C> | <C> | <C> |
| 10,437,840 | 6,107,963 | 581,725 | 45,332,913 |

</TABLE>

6. Adopting the 2004 Stock Option and Restricted Stock Purchase Plan:

<TABLE>
<CAPTION>

| VOTES FOR | VOTES AGAINST | ABSTENTIONS | SHARES NOT VOTING |
|---|---|---|---|
| <C> | <C> | <C> | <C> |
| 11,998,476 | 4,492,487 | 636,564 | 45,332,913 |

</TABLE>



ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) The following documents are filed as exhibits to this report:

| EXHIBIT NUMBER | DESCRIPTION |
|---|---|
| 4.1 | Form of Warrant dated July 14, 2004 |
| 10.1 | Stock Purchase Agreement dated as of July 15, 2004 between Arotech Corporation and Armour of America, Incorporated and its sole shareholder |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(b) The following reports on Form 8-K or Form 8-K/A were filed or furnished during the second quarter of 2004:

| DATE FILED | ITEM REPORTED |
|---|---|
| May 12, 2004 | Item 7 - Financial Statements, Pro Forma Financial Information and Exhibits; and Item 12 - Results of Operations and Financial Condition (furnished but not filed) |



SIGNATURES

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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: August 16, 2004

AROTECH CORPORATION

By: /s/ Robert S. Ehrlich
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Name: Robert S. Ehrlich
Title: Chairman, President and CEO
(Principal Executive Officer)

By: /s/ Avihai Shen
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Name: Avihai Shen
Title: Vice President - Finance
(Principal Financial Officer)



AROTECH CORPORATION

EXHIBIT INDEX

| EXHIBIT NUMBER | DESCRIPTION |
|---|---|
| 4.1 | Form of Warrant dated July 14, 2004 |
| 10.1 | Stock Purchase Agreement dated as of July 15, 2004 between Arotech Corporation and Armour of America, Incorporated and its sole shareholder |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

NEITHER THESE SECURITIES NOR THE SECURITIES INTO WHICH THESE SECURITIES ARE EXERCISABLE HAVE BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE SECURITIES COMMISSION OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS AS EVIDENCED BY A LEGAL OPINION OF COUNSEL TO THE TRANSFEROR TO SUCH EFFECT, THE SUBSTANCE OF WHICH SHALL BE REASONABLY ACCEPTABLE TO THE COMPANY. THESE SECURITIES AND THE SECURITIES ISSUABLE UPON EXERCISE OF THESE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN SECURED BY SUCH SECURITIES.

AROTECH CORPORATION

WARRANT

Warrant No.: _____

Number of Shares: _____

Date of Issuance: July 14, 2004 ("ISSUANCE DATE")

Arotech Corporation, a Delaware corporation (the "COMPANY"), hereby certifies that, for value received, the receipt and sufficiency of which are hereby acknowledged, _____, the registered holder hereof or its permitted assigns (the "HOLDER"), is entitled, subject to the terms set forth below, to purchase from the Company, at the Exercise Price (as defined below) then in effect, at any time or times on or after the date hereof, but not after 11:59 p.m., New York Time, on the Expiration Date (as defined below), _____ (_____) fully paid nonassessable shares of Common Stock (as defined below) (the "WARRANT SHARES"). Except as otherwise defined herein, capitalized terms in this warrant (including all Warrants issued in exchange, transfer or replacement hereof, the "WARRANTS") shall have the meanings set forth in Section 15.

The Company agrees that the Warrant Shares shall be treated as "Registrable Securities" in accordance with, and shall be governed by, identical terms to the Registration Rights Agreement, dated as of January 7, 2004, which provisions and terms should be applicable hereto mutates mutandis (as such agreement may be amended from time to time, the "REGISTRATION RIGHTS AGREEMENT"), by and among the Company and the buyers named therein, as if the Company and the Holder had executed such Registration Rights Agreement, and as if the Holder were party thereto, as of the Issuance Date; provided, however, that:

"EFFECTIVENESS DATE" shall mean with respect to the Registration Statement required to be filed thereunder relating to the Warrant Shares, the earlier of (1) (i) in the



event that the Registration Statement is not subject to a full review by the SEC, 90 days after the Issuance Date or (ii) in the event that the Registration Statement is subject to a full review by the SEC, 90 days after the Issuance Date, and (2) the fifth Business Day following the date on which the Company is notified by the SEC that such Registration Statement will not be reviewed or is no longer subject to further review and comments.

"FILING DATE" shall mean with respect to the Registration Statement required to be filed thereunder relating to the Warrant Shares, the 30th day following the Issuance Date.

For purposes of clarity, the issuance of this Warrant is unrelated to the

transaction pursuant to which the Registration Rights Agreement was entered into.

1. EXERCISE OF WARRANT.

(a) Mechanics of Exercise. Subject to the terms and conditions hereof (including, without limitation, the limitations set forth in Section 1(g)), this Warrant may be exercised by the Holder on any day from and after the date hereof, in whole or in part, by (i) delivery of a written notice, in the form attached hereto as Exhibit A (the "EXERCISE NOTICE"), of such Holder's election to exercise this Warrant, and (ii) (A) payment to the Company of an amount equal to the applicable Exercise Price multiplied by the number of Warrant Shares as to which this Warrant is being exercised (the "AGGREGATE EXERCISE PRICE") in cash or wire transfer of immediately available funds or (B) by notifying the Company that this Warrant is being exercised pursuant to a Cashless Exercise (as defined in Section 1(d)). The date the Exercise Notice and the Aggregate Exercise Price (or notice of a Cashless Exercise) are delivered to the Company (as determined in accordance with the notice provisions hereof) is an "EXERCISE DATE." The Holder shall not be required to deliver the original Warrant in order to effect an exercise hereunder. Execution and delivery of the Exercise Notice with respect to less than all of the Warrant Shares shall have the same effect as cancellation of the original Warrant and issuance of a new Warrant evidencing the right to purchase the remaining number of Warrant Shares. On or before the first Business Day following the Exercise Date, the Company shall transmit by facsimile an acknowledgment of confirmation of receipt of the Exercise Notice and the Aggregate Exercise Price to the Holder and the Company's transfer agent (the "TRANSFER AGENT"). On or before the third Business Day following the Exercise Date, the Company shall direct the Transfer Agent to credit through The Depository Trust Company ("DTC") Fast Automated Securities Transfer Program such aggregate number of shares of Common Stock to which the Holder is entitled pursuant to such exercise to the Holder's or its designee's balance account with DTC through its Deposit Withdrawal Agent Commission system. On the Exercise Date, the Holder shall be deemed for all corporate purposes to have become the holder of record of the Warrant Shares with respect to which this Warrant has been exercised, irrespective of the date of delivery of the certificates evidencing such Warrant Shares. Upon surrender of this Warrant to the Company following one or more partial exercises, the Company shall as soon as practicable and in no event later than three Business Days after receipt of the Warrant and at its own expense, issue a new Warrant (in accordance with Section 7(d)) representing the right to purchase the number of Warrant Shares



purchasable immediately prior to such exercise under this Warrant, less the number of Warrant Shares with respect to which this Warrant is exercised. No fractional shares of Common Stock are to be issued upon the exercise of this Warrant, but rather the number of shares of Common Stock to be issued shall be rounded up to the nearest whole number. The Company shall pay any and all taxes which may be payable with respect to the issuance and delivery of Warrant Shares upon exercise of this Warrant. In the event that the Company is unable to electronically deliver the Warrant Shares because of applicable securities laws, then the Company shall issue and deliver to the address as specified in the Exercise Notice a certificate, registered in the name of the Holder or its designee, for the number of shares of Common Stock to which the holder of this Warrant is entitled pursuant to such exercise.

(b) Exercise Price. For purposes of this Warrant, "EXERCISE PRICE" means the arithmetic average of the Weighted Average Price of the Common Stock over the period of July 15, 2004, July 16, 2004, and July 19, 2004, subject to adjustment as provided herein.

(c) Company's Failure to Timely Deliver Shares. Subject to Section 1(g), if the Company shall fail for any reason or for no reason within three Business Days of the Exercise Date to credit the Holder's balance account with DTC for such number of shares of Common Stock to which the Holder is entitled upon the Holder's exercise of this Warrant, and if after such third Business Day the Holder purchases (in an open market transaction or otherwise) shares of Common Stock to deliver in satisfaction of a sale by the Holder of the Warrant Shares that the Holder anticipated receiving from the Company (a "BUY-IN"), then the Company shall, within three Business Days after the Holder's request and in the Holder's discretion, either (i) pay cash to the Holder in an amount equal to the Holder's total purchase price (including brokerage

commissions, if any) for the shares of Common Stock so purchased (the "BUY-IN PRICE"), at which point the Company's obligation to issue such Common Stock shall terminate, or (ii) promptly honor its obligation to credit to the Holder such Common Stock and pay cash to the Holder in an amount equal to the excess (if any) of the Buy-In Price over the product of (A) such number of shares of Common Stock, times (B) the Closing Sale Price on the date of the event giving rise to the Company's obligation to deliver such certificate. Subject to Section 1(g), if the Company shall fail for any reason or for no reason within three Business Days of the Exercise Date to credit the Holder's balance account with DTC for such number of shares of Common Stock to which the Holder is entitled upon the Holder's exercise of this Warrant, then the Holder will have the right to rescind such exercise.

(d) Cashless Exercise. Notwithstanding anything contained herein to the contrary, if at any time during the period commencing ten (10) Business Days prior to the Holder's delivery of an Exercise Notice and ending on the day of delivery of the Exercise Notice, the Registration Statement (as defined in the Registration Rights Agreement) covering the Warrant Shares that are the subject of the Exercise Notice (the "UNAVAILABLE WARRANT SHARES") is not available for the issuance of such Unavailable Warrant Shares, the Holder may, in its sole discretion, exercise this Warrant in whole or in part and, in lieu of making the cash payment otherwise contemplated to be made to the Company upon such exercise in payment of the Aggregate Exercise Price, elect instead to receive upon such exercise the "Net Number" of shares of Common Stock determined according to the following formula (a "CASHLESS EXERCISE"):



$$\text{Net Number} = \frac{(A \times B) - (A \times C)}{B}$$

For purposes of the foregoing formula:

A = the total number of shares with respect to which this Warrant is then being exercised.

B = the Closing Sale Price of the Common Stock on the date immediately preceding the date of the Exercise Notice.

C = the Exercise Price then in effect for the applicable Warrant Shares at the time of such exercise.

(e) Absolute and Unconditional Obligation. The Company's obligations to issue and deliver Warrant Shares in accordance with the terms hereof are absolute and unconditional, irrespective of any action or inaction by the Holder to enforce the same, the recovery of any judgment against any Person or any action to enforce the same, or any setoff, counterclaim, recoupment, limitation or termination, or any breach or alleged breach by the Holder or any other Person of any obligation to the Company or any violation or alleged violation of law by the Holder or any other Person. Nothing herein shall limit the Holder's right to pursue any other remedies available to it hereunder, at law or in equity, including, without limitation, a decree of specific performance and/or injunctive relief with respect to the Company's failure to timely deliver certificates representing Warrant Shares upon exercise of the Warrant as required pursuant to the terms hereof.

(f) Disputes. In the case of a dispute as to the determination of the Exercise Price or the arithmetic calculation of the Warrant Shares, the Company shall promptly issue to the Holder the number of Warrant Shares that are not disputed and resolve such dispute in accordance with Section 12.

(g) Limitations on Exercises. The Company shall not effect the exercise of this Warrant, and no Person who is a holder of this Warrant shall have the right to exercise this Warrant, to the extent that after giving effect to such exercise, such Person (together with such Person's affiliates) would beneficially own in excess of 4.99% of the shares of the Common Stock outstanding immediately after giving effect to such exercise. For purposes of the foregoing sentence, the aggregate number of shares of Common Stock beneficially owned by such Person and its affiliates shall include the number of shares of Common Stock issuable upon exercise of this Warrant with respect to which the determination of such sentence is being made, but shall exclude shares

of Common Stock which would be issuable upon (i) exercise of the remaining, unexercised portion of this Warrant beneficially owned by such Person and its affiliates and (ii) exercise or conversion of the unexercised or unconverted portion of any other securities of the Company beneficially owned by such Person and its affiliates (including, without limitation, any convertible notes, convertible debentures, convertible preferred stock or warrants) subject to a



limitation on conversion or exercise analogous to the limitation contained herein. Except as set forth in the preceding sentence, for purposes of this paragraph, beneficial ownership shall be calculated in accordance with Section 13(d) of the Securities Exchange Act of 1934, as amended. For purposes of this Warrant, in determining the number of outstanding shares of Common Stock a Holder may rely on the number of outstanding shares of Common Stock as reflected in (1) the Company's most recent Form 10-Q, Form 10-K or other public filing with the Securities and Exchange Commission, as the case may be, (2) a more recent public announcement by the Company or (3) any other notice by the Company or its Transfer Agent setting forth the number of shares of Common Stock outstanding. For any reason at any time, upon the written or oral request of the Holder, the Company shall within two Business Days confirm orally and in writing to the Holder the number of shares of Common Stock then outstanding. In any case, the number of outstanding shares of Common Stock shall be determined after giving effect to the conversion or exercise of securities of the Company by the Holder and its affiliates since the date as of which such number of outstanding shares of Common Stock was reported.

The Company shall not be obligated to issue any shares of Common Stock upon exercise of this Warrant if the issuance of such shares of Common Stock would exceed that number of shares of Common Stock which the Company may issue upon exercise of this Warrant without breaching the Company's obligations under the rules or regulations of the Principal Market (the "EXCHANGE CAP"), except that such limitation shall not apply in the event that the Company obtains, only if required, the approval of its stockholders as required by the applicable rules of the Principal Market for issuances of shares of Common Stock in excess of such amount. Until such approval is obtained, the Holder shall not be issued, upon exercise of any Warrants, shares of Common Stock in an amount greater than the product of the Exchange Cap multiplied by a fraction, the numerator of which is the total number of shares of Common Stock underlying the Warrants issued to the Holder on the Issuance Date and the denominator of which is the aggregate number of shares of Common Stock underlying all the substantially identical warrants (the "EXCHANGE WARRANTS") issued by the Company on the Issuance Date (with respect to the Holder, the "EXCHANGE CAP ALLOCATION"). In the event that the Holder shall sell or otherwise transfer any of such Holder's Warrants, the transferee shall be allocated a pro rata portion of the Holder's Exchange Cap Allocation, and the restrictions of the prior sentence shall apply to such transferee with respect to the portion of the Exchange Cap Allocation allocated to such transferee. In the event that any holder of applicable warrants shall exercise all of such holder's applicable warrants into a number of shares of Common Stock which, in the aggregate, is less than such holder's Exchange Cap Allocation, then the difference between such holder's Exchange Cap Allocation and the number of shares of Common Stock actually issued to such holder shall be allocated to the respective Exchange Cap Allocations of the remaining holders of applicable warrants on a pro rata basis in proportion to the shares of Common Stock underlying the warrants then held by each such holder. In the event that the Company is prohibited from issuing any Warrant Shares for which an Exercise Notice has been received as a result of the operation of this paragraph, the Company shall pay cash in exchange for cancellation of such Warrant Shares, at a price per Warrant Share equal to the difference between the Closing Sale Price and the Exercise Price as of the date of the attempted exercise.



2. ADJUSTMENT OF EXERCISE PRICE AND NUMBER OF WARRANT SHARES UPON SUBDIVISION OR COMBINATION OF COMMON STOCK. If the Company at any time after the date of issuance of this Warrant subdivides (by any stock split, stock dividend, recapitalization or otherwise) one or more classes of its outstanding shares of Common Stock into a greater number of shares, the Exercise Price in effect immediately prior to such subdivision will be proportionately reduced and the number of Warrant Shares will be proportionately increased. If the Company at any time after the date of issuance of this Warrant combines (by combination,

reverse stock split or otherwise) one or more classes of its outstanding shares of Common Stock into a smaller number of shares, the Exercise Price in effect immediately prior to such combination will be proportionately increased and the number of Warrant Shares will be proportionately decreased. Any adjustment under this Section 2 shall become effective at the close of business on the date the subdivision or combination becomes effective.

3. RIGHTS UPON DISTRIBUTION OF ASSETS. If the Company shall declare or make any dividend or other distribution of its assets (or rights to acquire its assets) to holders of Common Stock, by way of return of capital or otherwise (including, without limitation, any distribution of cash, stock or other securities, property or options by way of a dividend, spin off, reclassification, corporate rearrangement or other similar transaction) (a "DISTRIBUTION"), at any time after the issuance of this Warrant, then, in each such case:

(a) any Exercise Price in effect immediately prior to the close of business on the record date fixed for the determination of holders of Common Stock entitled to receive the Distribution shall be reduced, effective as of the close of business on such record date, to a price determined by multiplying such Exercise Price by a fraction of which (i) the numerator shall be the Closing Bid Price of the Common Stock on the trading day immediately preceding such record date minus the value of the Distribution (as determined in good faith by the Company's Board of Directors) applicable to one share of Common Stock, and (ii) the denominator shall be the Closing Bid Price of the Common Stock on the trading day immediately preceding such record date; and

(b) the number of Warrant Shares shall be increased to a number of shares equal to the number of shares of Common Stock obtainable immediately prior to the close of business on the record date fixed for the determination of holders of Common Stock entitled to receive the Distribution multiplied by the reciprocal of the fraction set forth in the immediately preceding paragraph (a); provided that in the event that the Distribution is of common stock ("OTHER COMMON STOCK") of a company whose common stock is traded on a national securities exchange or a national automated quotation system, then the Holder may elect to receive a warrant to purchase Other Common Stock in lieu of an increase in the number of Warrant Shares, the terms of which shall be identical to those of this Warrant, except that such warrant shall be exercisable into the number of shares of Other Common Stock that would have been payable to the Holder pursuant to the Distribution had the Holder exercised this Warrant immediately prior to such record date and with an aggregate exercise price equal to the product of the amount by which the exercise price of this Warrant was decreased with respect to the Distribution pursuant to the terms of the immediately preceding paragraph (a) and the number of Warrant Shares calculated in accordance with the first part of this paragraph (b).



4. PURCHASE RIGHTS; ORGANIC CHANGE.

(a) Purchase Rights. In addition to any adjustments pursuant to Section 2 above, if at any time the Company grants, issues or sells any Options, Convertible Securities or rights to purchase stock, warrants, securities or other property pro rata to the record holders of any class of Common Stock (the "PURCHASE RIGHTS"), then the Holder will be entitled to acquire, upon the terms applicable to such Purchase Rights, the aggregate Purchase Rights which such Holder could have acquired if such Holder had held the number of shares of Common Stock acquirable upon complete exercise of this Warrant (without regard to any limitations on the exercise of this Warrant) immediately before the date on which a record is taken for the grant, issuance or sale of such Purchase Rights, or, if no such record is taken, the date as of which the record holders of Common Stock are to be determined for the grant, issue or sale of such Purchase Rights.

(b) Organic Change. Any recapitalization, reorganization, reclassification, consolidation, merger, sale of all or substantially all of the Company's assets to another Person or other transaction, in each case which is effected in such a way that holders of Common Stock are entitled to receive securities or assets with respect to or in exchange for Common Stock is referred to herein as an "ORGANIC CHANGE." Prior to the consummation of any (i) sale of all or substantially all of the Company's assets to an acquiring Person or (ii) other Organic Change following which the Company is not a surviving entity (for

purposes hereof a "surviving entity" means that this Warrant will continue to be exercisable for the publicly traded shares of a publicly traded entity), the Company will secure from the Person purchasing such assets or the Person issuing the securities or providing the assets in such Organic Change (in each case, the "ACQUIRING ENTITY") a written agreement (in form and substance reasonably satisfactory to the holders of warrants representing at least a majority of the shares of Common Stock obtainable upon exercise of the Exchange Warrants then outstanding) to deliver to the Holder in exchange for this Warrant, a security of the Acquiring Entity evidenced by a written instrument substantially similar in form and substance to this Warrant and reasonably satisfactory to the Holder (including, an adjusted exercise price equal to the value for the Common Stock reflected by the terms of such consolidation, merger or sale, and exercisable for a corresponding number of shares of Common Stock acquirable and receivable upon exercise of this Warrant (without regard to any limitations on the exercise of this Warrant), if the value so reflected is less than the Exercise Price in effect immediately prior to such consolidation, merger or sale). In the event that an Acquiring Entity is directly or indirectly controlled by a company or entity whose common stock or similar equity interest is listed, designated or quoted on a securities exchange or trading market, the Holder may elect to treat such Person as the Acquiring Entity for purposes of this Section 4(b). Prior to the consummation of any other Organic Change, the Company shall make appropriate provision (in form and substance reasonably satisfactory to the holders of Exchange Warrants representing at least a majority of the shares of Common Stock obtainable upon exercise of the Exchange Warrants then outstanding) to insure that the Holder thereafter will have the right to acquire and receive in lieu of or in addition to (as the case may be) the shares of Common Stock immediately theretofore acquirable and receivable upon the exercise of this Warrant (without regard to any limitations on the exercise of this Warrant), such shares of



stock, securities or assets that would have been issued or payable in such Organic Change with respect to or in exchange for the number of shares of Common Stock which would have been acquirable and receivable upon the exercise of this Warrant as of the date of such Organic Change (without regard to any limitations on the exercise of this Warrant).

5. NONCIRCUMVENTION. The Company hereby covenants and agrees that the Company will not, by amendment of its Certificate of Incorporation or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities, or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms of this Warrant, and will at all times in good faith carry out all the provisions of this Warrant and take all action as may be required to protect the rights of the Holder. Without limiting the generality of the foregoing, the Company (i) will not increase the par value of any shares of Common Stock receivable upon the exercise of this Warrant above the Exercise Price then in effect, (ii) will take all such actions as may be necessary or appropriate in order that the Company may validly and legally issue fully paid and nonassessable shares of Common Stock upon the exercise of this Warrant, and (iii) will, so long as any of the Warrants are outstanding, take all action necessary to reserve and keep available out of its authorized and unissued Common Stock, solely for the purpose of effecting the exercise of the Warrants, 100% of the number of shares of Common Stock as shall from time to time be necessary to effect the exercise of the Warrants then outstanding (without regard to any limitations on exercise).

6. HOLDER NOT DEEMED A STOCKHOLDER. Except as otherwise specifically provided herein, no Holder, solely in such Person's capacity as a holder of this Warrant, shall be entitled to vote or receive dividends or be deemed the holder of shares of the Company for any purpose, nor shall anything contained in this Warrant be construed to confer upon the Holder, solely in such Person's capacity as a Holder, any of the rights of a shareholder of the Company or any right to vote, give or withhold consent to any corporate action (whether any reorganization, issue of stock, reclassification of stock, consolidation, merger, conveyance or otherwise), receive notice of meetings, receive dividends or subscription rights, or otherwise, prior to the issuance to the Holder of the Warrant Shares which such Person is then entitled to receive upon the due exercise of this Warrant. In addition, nothing contained in this Warrant shall be construed as imposing any liabilities on such Holder to purchase any securities (upon exercise of this Warrant or otherwise) or as a stockholder of the Company, whether such liabilities are asserted by the Company or by creditors of the Company. Notwithstanding this Section 6, the Company will

provide the Holder with copies of the same notices and other information given to the stockholders of the Company generally, contemporaneously with the giving thereof to the stockholders.

7. REISSUANCE OF WARRANTS.

(a) Transfer of Warrant. If this Warrant is to be transferred, the Holder shall surrender this Warrant to the Company, whereupon the Company will forthwith issue and deliver upon the order of the Holder a new Warrant (in accordance with Section 7(d)), registered as the Holder may request, representing the right to purchase the number of Warrant Shares being



transferred by the Holder and, if less then the total number of Warrant Shares then underlying this Warrant is being transferred, a new Warrant (in accordance with Section 7(d)) to the Holder of this Warrant representing the right to purchase the number of Warrant Shares not being transferred.

(b) Lost, Stolen or Mutilated Warrant. Upon receipt by the Company of evidence reasonably satisfactory to the Company of the loss, theft, destruction or mutilation of this Warrant, and, in the case of loss, theft or destruction, of any indemnification undertaking by the Holder to the Company in customary form and, in the case of mutilation, upon surrender and cancellation of this Warrant, the Company shall execute and deliver to the Holder a new Warrant (in accordance with Section 7(d)) representing the right to purchase the Warrant Shares then underlying this Warrant.

(c) Warrant Exchangeable for Multiple Warrants. This Warrant is exchangeable, upon the surrender hereof by the Holder at the principal office of the Company, for a new Warrant or Warrants (in accordance with Section 7(d)) representing in the aggregate the right to purchase the number of Warrant Shares then underlying this Warrant, and each such new Warrant will represent the right to purchase such portion of such Warrant Shares as is designated by the Holder at the time of such surrender; provided, however, that no Warrants for fractional shares of Common Stock shall be given.

(d) Issuance of New Warrants. Whenever the Company is required to issue a new Warrant pursuant to the terms of this Warrant, such new Warrant (i) shall be of like tenor with this Warrant, (ii) shall represent, as indicated on the face of such new Warrant, the right to purchase the Warrant Shares then underlying this Warrant (or in the case of a new Warrant being issued pursuant to Section 7(a) or Section 7(c), the Warrant Shares designated by the Holder which, when added to the number of shares of Common Stock underlying the other new Warrants issued in connection with such issuance, does not exceed the number of Warrant Shares then underlying this Warrant), (iii) shall have an issuance date, as indicated on the face of such new Warrant which is the same as the Issuance Date, and (iv) shall have the same rights and conditions as this Warrant.

8. NOTICES. Any notices, consents, waivers or other communications required or permitted
to be given under the terms of this Warrant must be in writing and will be deemed to have been delivered: (i) upon receipt, when delivered personally; (ii) upon receipt, when sent by facsimile (provided confirmation of transmission is mechanically or electronically generated and kept on file by the sending party); or (iii) one Business Day after deposit with an overnight courier service, in each case properly addressed to the party to receive the same. The addresses and facsimile numbers for such communications shall be:

If to the Company:

Arotech Corporation
250 West 57th Street
Suite 310
New York, New York 10107
Facsimile No.: (212) 258-3281
Telephone No.: (212) 258-3222
Attn.: Chief Executive Officer

With a copy to:

Electric Fuel (E.F.L.) Ltd.
One HaSolela Street, POB 641
Western Industrial Park
Beit Shemesh 99000, Israel
Facsimile No.: 011-972-2-990-6688
Telephone No.: 011-972-2-990-6623
Attn.: General Counsel

If to the Holder, to its address and facsimile number set forth on the Schedule of Buyers to the Securities Purchase Agreement, dated as of January 7, 2004, among the Company and the investors referred to therein (the "JANUARY SPA"), or in the event that the Holder was not party to the January SPA, then as set forth on Exhibit B hereto, with copies to such Holder's representatives as set forth on such Schedule of Buyers,

With a copy to:

Schulte Roth & Zabel LLP
919 Third Avenue
New York, New York 10022
Facsimile No.: (212) 593-5955
Telephone No.: (212) 756-2000
Attn.: Eleazer Klein, Esq.

or to such other address and/or facsimile number and/or to the attention of such other Person as the recipient party has specified by written notice given to each other party five (5) days prior to the effectiveness of such change. Written confirmation of receipt (A) given by the recipient of such notice, consent, waiver or other communication, (B) mechanically or electronically generated by the sender's facsimile machine containing the time, date, recipient facsimile number and an image of the first page of such transmission or (C) provided by an overnight courier service shall be rebuttable evidence of personal service, receipt by facsimile or receipt from an overnight courier service in accordance with clause (i), (ii) or (iii) above, respectively.

The Company shall provide the Holder with prompt written notice of all actions taken pursuant to this Warrant, including in reasonable detail a description of such action and the reason therefore. Without limiting the generality of the foregoing, the Company will give written notice to the Holder (i) immediately upon any adjustment of the Exercise Price, setting forth in reasonable detail, and certifying, the calculation of such adjustment and (ii) promptly after the date on which the Company establishes a record date (A) with respect to any dividend or distribution upon the Common Stock, (B) with respect to any grants, issues or sales of any Options, Convertible Securities or rights to purchase stock, warrants, securities or other property to holders of Common Stock or (C) for determining rights to vote with respect to any Organic Change, dissolution



or liquidation, provided in each case that such information shall be made known to the public prior to or in conjunction with such notice being provided to the Holder.

9. AMENDMENT AND WAIVER. Except as otherwise provided herein, the provisions of this Warrant may be amended and the Company may take any action herein prohibited, or omit to perform any act herein required to be performed by it, only if the Company has obtained the written consent of the holders of Exchange Warrants representing at least a majority of the shares of Common Stock obtainable upon exercise of the Exchange Warrants then outstanding; provided that no such action may increase the exercise price of any Exchange Warrants or decrease the number of shares or class of stock obtainable upon exercise of any Exchange Warrants without the written consent of the Holder. No such amendment shall be effective to the extent that it applies to less than all of the holders of the Exchange Warrants then outstanding.

10. GOVERNING LAW. This Warrant shall be construed and enforced in accordance with, and all questions concerning the construction, validity, interpretation and performance of this Warrant shall be governed by, the internal laws of the State of New York, without giving effect to any choice of

law or conflict of law provision or rule (whether of the State of New York or any other jurisdictions) that would cause the application of the laws of any jurisdictions other than the State of New York.

11. CONSTRUCTION; HEADINGS. This Warrant shall be deemed to be jointly drafted by the Company and the Holder and shall not be construed against any person as the drafter hereof. The headings of this Warrant are for convenience of reference and shall not form part of, or affect the interpretation of, this Warrant.

12. DISPUTE RESOLUTION. In the case of a dispute as to the determination of the Exercise Price or the arithmetic calculation of the Warrant Shares, the Company shall submit the disputed determinations or arithmetic calculations via facsimile within two Business Days of receipt of the Exercise Notice giving rise to such dispute, as the case may be, to the Holder. If the Holder and the Company are unable to agree upon such determination or calculation of the Exercise Price or the Warrant Shares within three Business Days of such disputed determination or arithmetic calculation being submitted to the Holder, then the Company shall, within two Business Days submit via facsimile (a) the disputed determination of the Exercise Price to an independent, reputable investment bank selected by the Company and approved by the Holder or (b) the disputed arithmetic calculation of the Warrant Shares to the Company's independent, outside accountant. The Company shall cause at its expense the investment bank or the accountant, as the case may be, to perform the determinations or calculations and notify the Company and the Holder of the results no later than ten Business Days from the time it receives the disputed determinations or calculations. Such investment bank's or accountant's determination or calculation, as the case may be, shall be binding upon all parties absent demonstrable error.

13. REMEDIES, OTHER OBLIGATIONS, BREACHES AND INJUNCTIVE RELIEF. The remedies provided in this Warrant shall be cumulative and in addition to all other remedies available under this Warrant and the Registration Rights Agreement, at law or in equity (including a decree of specific performance and/or other injunctive relief), and nothing herein shall limit the right of the



Holder to pursue actual damages for any failure by the Company to comply with the terms of this Warrant. The Company acknowledges that a breach by it of its obligations hereunder will cause irreparable harm to the Holder and that the remedy at law for any such breach may be inadequate. The Company therefore agrees that, in the event of any such breach or threatened breach, the Holder shall be entitled, in addition to all other available remedies, to an injunction restraining any breach, without the necessity of showing economic loss and without any bond or other security being required.

14. TRANSFER. This Warrant may be offered for sale, sold, transferred or assigned without the consent of the Company.

15. CERTAIN DEFINITIONS. For purposes of this Warrant, the following terms shall have the following meanings:

"BLOOMBERG" means Bloomberg Financial Markets.

"BUSINESS DAY" means any day other than Saturday, Sunday or other day on which commercial banks in The City of New York are authorized or required by law to remain closed.

"CLOSING BID PRICE" and "CLOSING SALE PRICE" means, for any security as of any date, the last closing bid price and last closing trade price, respectively, for such security on the Principal Market, as reported by Bloomberg, or, if the Principal Market begins to operate on an extended hours basis and does not designate the closing bid price or the closing trade price, as the case may be, then the last bid price or last trade price, respectively, of such security prior to 4:00:00 p.m., New York Time, as reported by Bloomberg, or, if the Principal Market is not the principal securities exchange or trading market for such security, the last closing bid price or last trade price, respectively, of such security on the principal securities exchange or trading market where such security is listed or traded as reported by Bloomberg, or if the foregoing do not apply, the last closing bid price or last trade price, respectively, of such security in the over-the-counter market on the electronic

bulletin board for such security as reported by Bloomberg, or, if no closing bid price or last trade price, respectively, is reported for such security by Bloomberg, the average of the bid prices, or the ask prices, respectively, of any market makers for such security as reported in the "pink sheets" by Pink Sheets LLC (formerly the National Quotation Bureau, Inc.). If the Closing Bid Price or the Closing Sale Price cannot be calculated for a security on a particular date on any of the foregoing bases, the Closing Bid Price or the Closing Sale Price, as the case may be, of such security on such date shall be the fair market value as mutually determined by the Company and the Holder. If the Company and the Holder are unable to agree upon the fair market value of such security, then such dispute shall be resolved pursuant to Section 12. All such determinations to be appropriately adjusted for any stock dividend, stock split, stock combination or other similar transaction during the applicable calculation period.

"COMMON STOCK" means (i) the Company's common stock, par value $.01 per share, and (ii) any capital stock into which such Common Stock shall have been changed or any capital stock resulting from a reclassification of such Common Stock.



"CONVERTIBLE SECURITIES" means any stock or securities (other than Options) directly or indirectly convertible into or exercisable or exchangeable for Common Stock.

"EXPIRATION DATE" means July 14, 2009.

"OPTIONS" means any rights, warrants or options to subscribe for or purchase Common Stock or Convertible Securities.

"PERSON" means an individual, a limited liability company, a partnership, a joint venture, a corporation, a trust, an unincorporated organization, any other entity and a government or any department or agency thereof.

"PRINCIPAL MARKET" means the Nasdaq National Market.

"WEIGHTED AVERAGE PRICE" means, for any security as of any date, the dollar volume-weighted average price for such security on the Principal Market during the period beginning at 9:30:01 a.m., New York Time (or such other time as the Principal Market publicly announces is the official open of trading), and ending at 4:00:00 p.m., New York Time (or such other time as the Principal Market publicly announces is the official close of trading) as reported by Bloomberg through its "Volume at Price" functions, or, if the foregoing does not apply, the dollar volume-weighted average price of such security in the over-the-counter market on the electronic bulletin board for such security during the period beginning at 9:30:01 a.m., New York Time (or such other time as such market publicly announces is the official open of trading), and ending at 4:00:00 p.m., New York Time (or such other time as such market publicly announces is the official close of trading) as reported by Bloomberg, or, if no dollar volume-weighted average price is reported for such security by Bloomberg for such hours, the average of the highest closing bid price and the lowest closing ask price of any of the market makers for such security as reported in the "pink sheets" by Pink Sheets LLC (formerly the National Quotation Bureau, Inc.). If the Weighted Average Price cannot be calculated for a security on a particular date on any of the foregoing bases, the Weighted Average Price of such security on such date shall be the fair market value as mutually determined by the Company and the Holder. If the Company and the Holder are unable to agree upon the fair market value of such security, then such dispute shall be resolved pursuant to Section 12. All such determinations to be appropriately adjusted for any stock dividend, stock split, stock combination or other similar transaction during the applicable calculation period.

16. January SPA Provisions. The Company and the Holder hereby make to each other the representations and warranties as to the Warrants and the Warrant Shares as set forth in the January SPA as if such representations and warranties were set forth herein, mutates mutandis. The Company hereby agrees to issue transfer agent instructions substantially identical to, and subject to the same terms and conditions, as the Transfer Agent Instructions referenced in the January SPA and that the Warrants and Warrant Shares shall be governed by the provisions of Section 4(b) of the January SPA as if such provisions were set

forth in full herein.

[SIGNATURE PAGE FOLLOWS]



IN WITNESS WHEREOF, the Company has caused this Warrant to be duly executed by its authorized officer as of the date first indicated above.

AROTECH CORPORATION

By: _____
Name: Robert S. Ehrlich
Title: Chief Executive Officer



EXHIBIT A

EXERCISE NOTICE
TO BE EXECUTED BY THE REGISTERED HOLDER TO EXERCISE THIS WARRANT

AROTECH CORPORATION

To: Arotech Corporation

The undersigned is the Holder of Warrant No. _____ (the "WARRANT") issued by Arotech Corporation, a Delaware corporation (the "COMPANY"). Capitalized terms used herein and not otherwise defined shall have the respective meanings set forth in the Warrant.

1. The Warrant is currently exercisable to purchase a total of _____ Warrant Shares.

2. The undersigned holder hereby exercises its right to purchase _____ Warrant Shares pursuant to the Warrant.

3. The Holder intends that payment of the Exercise Price shall be made as:

_____ a "Cash Exercise" with respect to _____ Warrant Shares; and/or

_____ a "Cashless Exercise" with respect to _____ Warrant Shares.

4. Pursuant to this exercise, the Company shall deliver to the holder _____ Warrant Shares in accordance with the terms of the Warrant.

5. Following this exercise, the Warrant shall be exercisable to purchase a total of _____ Warrant Shares.

Please issue the Warrant Shares in the following name and to the following address:

Issue to: _____

_____

Account Number: _____

DTC Participant Number: _____

Date: _____ __, _____

- ----------
Name of Registered Holder

By:
---
Name:
Title:

ACKNOWLEDGMENT

The Company hereby acknowledges this Exercise Notice and hereby directs American Stock Transfer & Trust Co. to issue the above indicated number of shares of Common Stock in accordance with the Transfer Agent Instructions dated July 14, 2004, from the Company and acknowledged and agreed to by American Stock Transfer & Trust Co.

AROTECH CORPORATION

By:
---
Name:
Title:

FORM OF ASSIGNMENT

[To be completed and signed only upon transfer of Warrant]

FOR VALUE RECEIVED, the undersigned hereby sells, assigns and transfers unto _____ the right represented by the within Warrant to purchase _____ shares of Common Stock of Arotech Corporation to which the within Warrant relates and appoints _____ attorney to transfer said right on the books of Arotech Corporation with full power of substitution in the premises.

Dated: ---------- , -----

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(Signature must conform in all respects to name of Holder as specified on the face of the Warrant)

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Address of Transferee

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In the presence of:

- ----------

EXHIBIT B

Address for Notices

EXHIBIT 10.1

# STOCK PURCHASE AGREEMENT

AGREEMENT (the "AGREEMENT"), dated as of July 15, 2004, is between and among AROTECH CORPORATION, a Delaware corporation (the "BUYER") with its principal place of business located at 250 West 57th Street, Suite 310, New York, New York 10107, ARMOUR OF AMERICA, INCORPORATED, a California corporation with its principal place of business at 1814 West 135th Street, Gardena, California 90249 (the "COMPANY"), and ARTHUR G. SCHREIBER, the sole shareholder of the Company, with a principal residence at 211 Spalding Drive #101N, Beverly Hills, California 90212 (the "SHAREHOLDER").

WHEREAS, the Buyer has proposed to purchase and the Shareholder has proposed to sell all of the outstanding shares of Common Stock issued by the Company (the "COMPANY COMMON STOCK") and the shareholder and sole member of the Board of Directors of the Company has determined that it is in the best interests of the Company and the Shareholder to consent to that purchase and sale (the "PURCHASE/SALE") upon the terms and conditions set forth herein;

NOW, THEREFORE, the Buyer, the Company and the Shareholder hereby agree as follows:

## ARTICLE I

## DEFINITIONS

1.1 DEFINED TERMS. For the purposes of this Agreement, the terms listed below shall have the following meanings:

1.1.1 "AGREEMENT" shall mean this agreement, as it may be amended from time to time.

1.1.2 "AROTECH COMMON STOCK" shall mean the Common Stock, with $0.01 par value, issued by the Buyer.

1.1.3 "ASSOCIATION" shall have the meaning defined in Section 10.2.

1.1.4 "BURDENSOME CONDITION" shall have the meaning defined in Sections 6.2.9.

1.1.5 "BUYER" shall mean Arotech Corporation, a Delaware corporation.

1.1.6 "BUYER'S ACCOUNTANT" shall mean Stark, Winter, Schenkein & Co., LLP, or any other certified public accountant that shall be designated by Buyer.

1.1.7 "CLAIM" shall have the meaning defined in Section 8.4.

1.1.8 "CLOSING" shall have the meaning defined in Section 7.1.

1.1.9 "CLOSING CONSIDERATION" shall have the meaning defined in Section 2.3.

1.1.10 "CLOSING CASH CONSIDERATION" shall have the meaning defined in Section 2.3.

1.1.11 "CLOSING DATE" shall have the meaning defined in Section 7.1.

1.1.12 "CODE" shall mean the Internal Revenue Code of 1986, as amended.

1.1.13 "COMPANY" shall mean Armour of America, Inc., a California corporation.

1.1.14 "COMPANY COMMON STOCK" shall mean the Company's Common

Stock, par value $1.00 per share.

1.1.15 "COMPANY FINANCIAL STATEMENTS" shall have the meaning defined in Section 3.14.

1.1.16 "DISCLOSURE SCHEDULE" shall have the meaning defined in Section 1.3.

1.1.17 "DISPUTE NOTICE" shall have the meaning defined in Section 10.1.

1.1.18 "DOWN PAYMENT" shall have the meaning defined in Section 2.3.1.

1.1.19 "EBIT" shall mean the income of the Company before any deductions for interest expenses or taxes, but otherwise as determined in accordance with generally accepted accounting principles, consistently applied from period to period.

1.1.20 "EBIT CALCULATION PERIOD" shall have the meaning defined in Section 2.5.3.

1.1.21 "EARNOUT CONSIDERATION" shall have the meaning defined in Section 2.5.

1.1.22 "EARNOUT ORDER" shall have the meaning defined in Section 2.5.1.

1.1.23 "EARNOUT STOCK CONSIDERATION" shall have the meaning defined in Section 2.5.1.

1.1.24 "ESCROW AGENT" shall mean M. Neil Cummings, Esq.

1.1.25 "ESCROW AGREEMENT" shall have the meaning defined in Section 2.3.

1.1.26 "ESCROW CONSIDERATION" shall have the meaning defined in Section 2.3.



1.1.27 "ESCROW ORDER" shall have the meaning defined in Section 2.4.1.

1.1.28 "EXTRAORDINARY COSTS" shall have the meaning defined in Section 2.5.4.

1.1.29 "FORCE MAJEURE" with respect to any party to this Agreement shall mean all prevention, delays or stoppages when the same is caused by and due to Acts of God (e.g., fire, flood, earthquake) and extraordinary acts of man (e.g., war, insurrection, civil unrest, strike) and/or other extraordinary, causes not reasonably foreseeable and beyond the reasonable control of the party obligated to perform, except that Force Majeure shall only excuse the performance of such party for the period of time equal to the duration of any such prevention, delays and/or stoppages, after which time the performance of all obligations under this Agreement shall no longer be excused. The inability of Buyer to raise or pay all or any part of the Purchase Price due to a loan, credit application or asset sale being denied or refused by a lender or lenders, or a buyer or buyers, shall not be considered Force Majeure.

1.1.30 "GOVERNMENTAL AUTHORITY" shall mean any nation, territory or government, foreign or domestic, any state, local or other political subdivision thereof, and any bureau, tribunal, board, commission, department, agency or other entity exercising executive, legislative, judicial, regulatory or administrative functions of government, including, without limitation, all taxing authorities.

1.1.31 "INDEMNIFIED PARTY" shall have the meaning defined in Section 8.3.

1.1.32 "INDEMNIFYING PARTIES" shall have the meaning defined in Section 8.4.

1.1.33 "INDEMNITY NOTICE" shall have the meaning defined in Section 8.4.

1.1.34 "INTELLECTUAL PROPERTY" shall mean any and all proprietary technology, knowledge, formulas, specifications, processes, techniques, technical data and other know-how, whether now existing or hereafter developed, including without limitation Patents and Marks, to which the Company has any rights. Until such time as any particular patent has issued in accordance with the terms of a patent application, the term "Intellectual Property" shall be deemed to include all inventions claimed in such patent application. The term "Intellectual Property" shall also include all proprietary technology, knowledge, formulas, specifications, processes, techniques, technical data and other know-how included in any patent application but which have not been included within an allowed claim in any patent.

1.1.35 "INTERIM FINANCIAL STATEMENTS" shall have the meaning defined in Section 3.14.



1.1.36 "LIEN" shall mean any interest, consensual or otherwise, in property, whether real, personal or mixed property or assets, tangible or intangible, securing an obligation owed to, or a claim by a third Person, or otherwise evidencing an interest of a Person other than the owner of the property, whether such interest is based on common law, statute or contract, and including, but not limited to, any security interest, security title or lien arising from a mortgage, recordation of abstract of judgment, deed of trust, deed to secure debt, encumbrance, restriction, charge, covenant, restriction, claim, exception, encroachment, easement, right of way, license, permit, incorporeal hereditament, pledge, conditional sale, option trust (constructive or otherwise) or trust receipt or a lease, consignment or bailment for security purposes and other title exceptions and encumbrances affecting the property.

1.1.37 "LOSSES" shall have the meaning defined in Section 8.1.

1.1.38 "MARKS" shall mean all trademarks, service marks, trade dress and trade names, including all registrations and applications with respect thereto, and all copyright registrations owned by the Company or in which the Company has any rights or licenses.

1.1.39 "MATERIAL ADVERSE CHANGE" means any material adverse change in the business (as now conducted or as proposed to be conducted by the Company at the date hereof and at the Closing Date), assets, financial condition, liabilities, operations or prospects of the Company.

1.1.40 "MATERIAL ADVERSE EFFECT" means any material adverse effect on the business (as now conducted or as proposed to be conducted by the Company at the date hereof and at the Closing Date), assets, financial condition, liabilities, operations or prospects of the Company.

1.1.41 "ORGANIZATIONAL DOCUMENTS" shall mean a corporation's Articles of Incorporation, Certificate of Incorporation, By-Laws or equivalent organizational documents.

1.1.42 "PATENTS" shall mean shall mean the Company's right, title and interest in and to all unexpired domestic and foreign patents, patent applications, similar grants and applications therefor, and any improvements, continuations, continuations-in-part, divisionals, extensions, reissues, reexaminations or substitutions thereof, and any and all inventions embodied within the foregoing.

1.1.43 "PERSON" shall mean any individual or any corporate or other entity, including without limitation federal, state, local and foreign governmental agencies and all subdivisions thereof.

1.1.44 "PLAN" shall have the meaning defined in Section 3.19.



1.1.45 "PURCHASE PRICE" shall have the meaning defined in Section 2.2.

1.1.46 "PURCHASE/SALE" shall mean the purchase and sale of the Company Common Stock pursuant to this Agreement

1.1.47 "REQUISITE REGULATORY APPROVAL" shall have the meaning defined in Section 6.1.2.

1.1.48 "RESOLUTION NOTICE" shall have the meaning defined in Section 10.1.

1.1.49 "REVIEW NOTICE" shall have the meaning defined in Section 10.1.

1.1.50 "SHAREHOLDER" shall mean Arthur G. Schreiber.

1.1.51 "SHAREHOLDER'S ACCOUNTANT" shall mean Castillo & Ebenhoch.

1.1.52 "STOCK DEPOSIT DATE" shall have the meaning defined in Section 2.5.1.

1.1.53 "SUBCHAPTER S TAX LIABILITY" shall mean the federal and state income Taxes payable by the Shareholder with respect to the taxable income realized by the Company in 2003 and 2004 that is allocated to the Shareholder pursuant to Subchapter S of the Code, calculated for the Shareholder upon the assumption that such allocated taxable income will be subject to income tax at the highest marginal rate under the Code or other applicable taxing statute.

1.1.54 "TAX" means any federal, state, local, or foreign income, gross receipts, license, payroll, employment, excise, severance, stamp, occupation, premium, windfall profits, environmental (including taxes under Code ss. 59A), customs duties, capital stock, franchise, profits, withholding, social security (or similar), unemployment, disability, real property, personal property, sales, use, transfer, registration, value added, alternative or add-on minimum, estimated, or other tax, assessment or levy of any kind whatsoever, including any interest, penalty, or addition thereto, whether disputed or not.

1.1.55 "TAX RETURN" means any federal, state, local or foreign return, declaration, report, claim for refund, or information return or statement relating to Taxes, including any schedule or attachment thereto, and including any amendment thereof.

1.1.56 "TRADE SECRETS" shall mean shall mean any and all proprietary technology, knowledge, formulas, specifications, processes, techniques, technical data and other know-how, whether now existing or hereafter developed, to which the Company has any rights. Until such time as any particular patent has issued in accordance with the terms of a patent application, the term "Trade Secrets" shall be deemed to include all inventions claimed in such patent application. The term "Trade Secrets" shall also include all proprietary technology,



knowledge, formulas, specifications, processes, techniques, technical data and other know-how included in any patent application but which have not been included within an allowed claim in any patent.

1.1.57 "UNAFFILIATED ACCOUNTANT" shall have the meaning defined in Section 10.1.

1.2 OTHER DEFINITIONAL MATTERS. Other terms used herein are defined in

the preamble and elsewhere in this Agreement Terms defined in the singular shall have a comparable meaning when used in the plural, and vice versa.

1.3 DISCLOSURE STANDARDS. Immediately prior to the execution and delivery of this Agreement, the Shareholder has delivered to the Buyer, and the Buyer has delivered to the Shareholder, a schedule ("DISCLOSURE SCHEDULE") setting forth, among other things, on schedules corresponding to the Sections hereof, items the disclosure of which is necessary or appropriate either in response to an express disclosure requirement contained in a provision hereof or as an exception to one or more of such party's representations, warranties or covenants contained in this Agreement, or that are necessary to make the statements made in this Agreement and in the Disclosure Schedule, individually and taken as a whole, not misleading.

## ARTICLE II

## PURCHASE/SALE AND TRANSFER OF COMPANY COMMON STOCK

2.1 PURCHASE/SALE. Subject to the terms and conditions of this Agreement, the Buyer shall purchase and the Shareholder shall sell all of the Company Common Stock at the Closing, effective as of the Closing Date.

2.2 PURCHASE PRICE. The aggregate purchase price (the "PURCHASE PRICE") for all of the issued and outstanding shares of the Company Common Stock is the sum of the Closing Consideration established pursuant to Section 2.3 and the Earnout Consideration established pursuant to Section 2.5; provided, however, that under no circumstances shall the aggregate Purchase Price to be paid by the Buyer be in excess of $40,000,000.

2.3 CLOSING CONSIDERATION. The portion of the Purchase Price payable in cash at the Closing (the "CLOSING CONSIDERATION") will be an amount equal to (i) $22,000,000 in cash to the Shareholder at the closing (the "CLOSING CASH CONSIDERATION"), and (ii) $3,000,000 in cash (the "ESCROW CONSIDERATION") to the Escrow Agent, to be held in an escrow account (the "ESCROW ACCOUNT") pursuant to the terms of an escrow agreement in substantially the form of Exhibit 2.3 hereto (the "ESCROW AGREEMENT"), a copy of which has been executed by the parties thereto simultaneously with the execution of this Agreement.

2.3.1 On or prior to the date hereof, the Buyer has transferred to the Escrow Agent the sum of $500,000 (the "DOWN PAYMENT"), receipt of which the Shareholder hereby acknowledges, to be held by the Escrow Agent in the Escrow Account pursuant to the terms of the Escrow Agreement.



2.3.2 The Closing Cash Consideration shall be paid at the Closing by (i) release to the Shareholder of the Down Payment, and (ii) delivery to the Shareholder by wire transfer of funds to an account specified by the Shareholder pursuant to Section 7.2.1 hereof in the amount of $21,500,000, or such lesser amount as shall be due after operation of the provisions of Section 7.1 hereof.

2.3.3 The Escrow Consideration shall be paid at the Closing by wire transfer of funds to an account specified by the Escrow Agent pursuant to Section 7.2.2 hereof in the amount of $3,000,000, to be held in escrow in the Escrow Account pursuant to the terms of the Escrow Agreement.

2.4 ESCROW CONSIDERATION. The Escrow Consideration shall be released from the Escrow Account as follows:

2.4.1 Within 15 days after the receipt by the Company prior to December 31, 2005 and delivery to the Escrow Agent of signed purchase orders or contracts, with estimated gross profit margins relatively consistent with historical levels, from specific programs that are identified in writing by the Buyer and the Shareholder, in the cumulative amount of not less than $2,000,000 (an "ESCROW ORDER"), the amount of $3,000,000 will be released to the Shareholder from the Escrow Account. Any dispute with respect to this subsection shall be resolved in the manner specified in Section 10.1.

2.4.2 Any money remaining in the Escrow Account on January 1, 2006 shall be returned to the Buyer as soon as practicable after such date.

2.5 EARNOUT CONSIDERATION. The portion of the Purchase Price payable on the basis of the operations of the Company following the Closing (the "EARNOUT CONSIDERATION") will equal the following:

2.5.1 If at any time prior to December 31, 2005 the Company receives signed purchase orders or contracts, which shall be promptly delivered to the Escrow Agent, with estimated gross profit margins relatively consistent with historical levels, in the cumulative amount of at least $15,000,000, from specific programs that are identified in writing by the Buyer and the Shareholder (an "EARNOUT ORDER"), then the Buyer shall pay or shall cause the Company to pay and deliver to the Shareholder cash or, at Buyer's option, an amount in Arotech Common Stock having a value equal to $15,000,000 (the "EARNOUT STOCK CONSIDERATION"), with such payment and delivery to be made 15 days after receipt of such a signed purchase order or contract, (the "STOCK DEPOSIT DATE"). The number of shares of Arotech Common Stock to be delivered to the Shareholder shall be determined based upon the average of the last sale price during the five trading days immediately preceding the date of the Earnout Order. The Buyer shall then have a period of up to 60 days after the Stock Deposit Date in which to register and sell the Earnout Stock Consideration, such that the Shareholder receives $15,000,000 in net cash proceeds pursuant to the procedures established in Section 2.5.2 below. Any questions regarding



the computation of the Earnout Stock Consideration shall be resolved in the manner specified in Section 10.1. The Buyer, Shareholder and the Company shall use their commercially reasonable best efforts to obtain such signed purchase orders or contracts for the Earnout Order by December 31, 2005. However, the Shareholder shall receive the Earnout Stock Consideration if the Earnout Order is a linked contract consisting of a prototype order obtained by December 31, 2005 followed by a production order, the latter of which must be signed by June 30, 2006.

2.5.2 In connection with the Earnout Stock Consideration, the Buyer will implement as rapidly as possible the sale, in one or more transactions, of that number of the shares of the Earnout Stock Consideration as will be required to generate net proceeds to the Shareholder (after all transactional expenses) of $15,000,000 and, within three (3) business days following each such sale, to disburse such net proceeds to the Shareholder by wire transfer to an account or accounts designated by the Shareholder. Unless at the written directive of the Shareholder, no sales of shares of the Earnout Stock Consideration will be completed at a price that is less than 80% of the price per share that was the valuation basis for the issuance of the Earnout Stock Consideration. All cumulative net proceeds in excess of $15,000,000 shall be delivered to the Buyer. If any such excess cumulative net proceeds are not delivered to the Buyer, the Buyer may deduct an amount equal to such excess cumulative net proceeds from any Earnout Consideration to be paid. If as of the sixtieth (60th) day following the Stock Deposit Date, the cumulative net proceeds from the sale of the Earnout Stock Consideration distributed to the Shareholder equals less than $15,000,000, then the Shareholder shall have the right, as of or at any time after such sixtieth (60th) day, exercisable by written notice delivered to the Buyer, to require that the Buyer pay to the Shareholder in cash any remaining sums due in order to cause the amount of Earnout Stock Consideration paid to be equal to $15,000,000.

2.5.3 The Buyer shall pay to the Shareholder as the Earnout Consideration for operations of the Company an additional amount, one-half in cash and one-half in registered stock (valued at the average of the last sale price of the Buyer's common stock on the Nasdaq National Market during the five trading days immediately preceding the payment date) equal to the amount, if any, by which (i) 3.0 times the amount by which EBIT realized by the Company from all operations (not including any EBIT realized by the Company from a

Navair CH-46 order (under contract dated 6/10/04), an Escrow Order, and/or an Earnout Order which have become part of the Purchase Price) during the eighteen months ending December 31, 2005 (the "EBIT CALCULATION PERIOD") exceeds (ii) $9,000,000; provided, however, that under no circumstances shall the amount of Earnout Consideration payable by the Buyer pursuant to this subsection exceed $7,000,000. However, if the Shareholder does not receive any Escrow Consideration and/or Earnout Stock Consideration, then the EBIT contribution from the respective contracts that could have resulted in such Consideration shall be included in the EBIT Calculation Period. For such purposes the EBIT realized by the Company for the EBIT Calculation Period will be



determined in accordance with U.S. generally accepted accounting principles consistently applied from period to period, but subject to the limitation on Extraordinary Costs of the Company as provided in Section 2.5.4. The Buyer will cause the Buyer Accountants, not later than March 31, 2006, to prepare and deliver to the Shareholder and the Buyer an audited financial statement of the Company for the EBIT Calculation Period, together with a computation prepared by the Buyer's Accountants of the Company's EBIT for the EBIT Calculation Period based upon the information contained in that financial statement and the Earnout Consideration payable to the Shareholder based upon that EBIT. Not later than April 30, 2006, the Buyer shall pay to the Shareholder, by wire transfer of funds, the amount specified by the Buyer's Accountants as the Earnout Consideration. Any questions regarding that computation of the Earnout Consideration shall be resolved in the manner specified in Section 10.1.

2.5.4 During the EBIT Calculation Period, the Buyer will cause the operation of the Company's business to be conducted in a commercially reasonable manner consistent with past practices and in the ordinary course. In computing the EBIT for purposes of the Earnout Consideration, expenses outside the ordinary course that are not consistent with past practices ("EXTRAORDINARY COSTS") shall not be deducted from EBIT, it being agreed that all costs in connection with the addition of a marketing manager, an operations manager, and the leasing of additional space shall not be considered Extraordinary Costs.

2.5.5 If the EBIT for the EBIT Calculation Period (not including EBIT realized by the Company from a Navair CH-46 order (under contract dated 6/10/04), an Escrow Order, and/or an Earnout Order) equals or exceeds $9.0 million, and EBIT for the twelve months ended June 30, 2004 (not including any EBIT realized by the Company from a Navair CH-46 order (under contract dated 6/10/04), an Escrow Order, and/or an Earnout Order) equals or exceeds $6.0 million, then Buyer shall pay Shareholder by wire transfer of funds, by no later than April 30, 2006, the amount of such EBIT for the twelve months ended June 30, 2004 that is in excess of $6.0 million. However, if the Shareholder does not receive any Escrow Consideration and/or Earnout Stock Consideration, then the EBIT contribution from the respective contracts that could have resulted in such Consideration shall be included in the EBIT Calculation Period.

2.5.6 In the event that prior to December 31, 2005, (i) the Buyer shall sell the Company or its business, or (ii) the Buyer shall sell fifty and one tenth percent (50.1%) of the Common Stock of the Buyer, or (iii) the Buyer shall sell or cede majority control of the Board of Directors of the Buyer, the amount of the Escrow and Earnout Consideration shall be a lump-sum payment of $7,000,000, irrespective of the C-17 contract status or the level of EBIT achieved, and shall be paid within 10 days of such event. The Escrow Consideration and the Earnout Consideration associated with the Earnout Order shall be obligations of the Company to be assumed by any purchaser of the assets or stock of the Company, and shall remain in full force and effect as



obligations of the Company. However, such payments cannot result in the

Purchase Price exceeding $40,000,000.

2.6 TRANSFER OF SHARES. At the Closing, the Shareholder shall transfer all of the shares of Company Common Stock registered in the Shareholder's name or otherwise beneficially owned by the Shareholder to the Buyer by endorsing (by means of an undated stock power executed in blank) and delivering to the Buyer the original Stock Certificate(s) representing such shares of Company Common Stock.

## ARTICLE III

## REPRESENTATIONS AND WARRANTIES OF THE SHAREHOLDER

The Shareholder hereby represents and warrants to the Buyer that:

3.1 ORGANIZATION. The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of California and has all requisite corporate power and authority to own and lease its properties, to carry on its business as presently conducted and as proposed to be conducted and to carry out the transactions contemplated hereby. The Company is not, by the manner in which it conducts its business or owns or leases its property, required to be qualified as a foreign corporation to do business in any other jurisdictions. The Disclosure Schedules contain true, complete and accurate copies of the Organizational Documents of the Company.

3.2 ORGANIZATIONAL DOCUMENTS; CORPORATE RECORDS. The Company has heretofore made available to the Buyer a complete and correct copy of its Organizational Documents, each as amended to date. Such Organizational Documents are in full force and effect. The Company is not in violation of any provision of its Organizational Documents. The minute books of the Company, which have heretofore been made available in their entirety to the Buyer, contain in all material respects true and correct records of all meetings held or true and complete records of all other corporate actions taken at any time by written consent or otherwise by its shareholders or Board of Directors or by any committee of the Board of Directors.

3.3 CAPITALIZATION.

3.3.1 The authorized capital stock of the Company consists of seventy-five thousand (75,000) shares of the Company Common Stock. As of the date hereof and as of the Closing Date and the Closing, one hundred thirteen (113) shares of the Company Common Stock are issued and outstanding, all of which are duly authorized, validly issued, fully paid, nonassessable and free of preemptive rights, with no personal liability attaching to the ownership thereof.

3.3.2 Except as set forth in Schedule 3.3.2, (i) there are no outstanding subscriptions, options, warrants, calls, preemptive or other rights, agreements, arrangements or commitments of any character relating to the issued or unissued capital stock of the Company or obligating the Company to issue or sell any shares of capital stock of, or other equity interests in, the Company and (ii) there are no outstanding contractual obligations of the Company to repurchase, redeem or otherwise acquire any shares of capital stock of, or other



equity interests in, the Company or to provide funds to, or make any investment (in the form of a loan, capital contribution or otherwise) in, any other entity.

3.4 OWNERSHIP OF COMPANY COMMON STOCK. All of the shares of Company Common Stock are held of record and beneficially by the Shareholder, in the amount set forth opposite the Shareholder's name on the signature page hereof, free and clear of all Liens of any nature whatsoever, and no other shares of Company Common Stock are issued or outstanding. All of the shares of Common Stock are duly authorized, validly issued in compliance with all applicable laws, and are fully paid and nonassessable and free of preemptive or similar rights created by statute, the Organizational Documents of the Company, or any other agreement to which the Company is a party or by which it is bound.

3.5 AUTHORITY.

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3.5.1 The Shareholder has the requisite legal capacity, power and authority to enter into and to perform his obligations under this Agreement and this Agreement has been duly and validly executed and delivered by the Shareholder and constitutes the valid and binding obligation of the Shareholder, enforceable against the Shareholder in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, moratorium and other similar laws of general applicability relating to or affecting creditors' rights generally and by the application of general principles of equity.

3.5.2 The Company has full corporate power and authority (i) to execute and deliver this Agreement; (ii) to perform its obligations under this Agreement and (iii) to consummate the transactions contemplated by this Agreement. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly approved by the Board of Directors and shareholders of the Company and no other corporate or other proceedings on the part of the Company are necessary to approve this Agreement or to consummate the transactions contemplated hereby. This Agreement has been duly and validly executed and delivered by the Company and constitutes valid and binding obligations of the Company, enforceable against the Company in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, moratorium and other similar laws of general applicability relating to or affecting creditors' rights generally and by the application of general principles of equity.

3.6 NO CONFLICT.

3.6.1 Except as provided in Schedule 3.6, neither the execution, delivery and performance of this Agreement by the Company, nor the consummation by the Company of the transactions contemplated hereby or thereby, nor compliance by the Company with any of the terms or provisions hereof or thereof, will (i) conflict with, violate or result in a breach of any provision of the Organizational Documents of the Company, (ii) conflict with, violate or result in a breach of any



statute, code, ordinance, rule, regulation, order, writ, judgment, injunction or decree applicable to the Company, or by which any property or asset of the Company is bound or affected, or (iii) conflict with, violate or result in a breach of any provisions of or the loss of any benefit under, constitute a default (or an event, which, with notice or lapse of time, or both, would constitute a default) under, or, except as set forth in Schedule 3.6, give to others any right of termination, amendment, acceleration or cancellation of, or result in the creation of a lien, pledge, security interest, charge or other encumbrance on any property or asset of the Company pursuant to any of the terms, conditions or provisions of any note, bond, mortgage, indenture, deed of trust, contract, agreement, lease, license, permit, franchise or other instrument or obligation to which the Company is a party, or by which the Company is bound or affected.

3.6.2 Except as provided in Schedule 3.6, neither the execution, delivery nor performance of this Agreement by the Shareholder nor the consummation of the transactions contemplated hereby, nor compliance by the Shareholder with any of the terms and conditions hereof, will (i) conflict with, violate or result in the breach of any provision of any statute, code, ordinance, rule, regulation, order, writ, judgment, injunction or decree applicable to the Company or to the Shareholder or by which the Company Common Stock held by the Shareholder is bound or affected or (ii) conflict with, violate or result in the breach of any provision of or any loss of any benefit under, constitute a default (or an event, which, with notice of lapse of time or both, will constitute a default) under or result in the creation of a Lien, pledge, security interest, charge or any other encumbrance on any Company Common Stock owned by the Shareholder, pursuant to any of the terms, conditions or provisions of any note, bond, mortgage, indenture, deed of trust, contract, agreement, lease,

license, permit, franchise or other instrument or other obligation to which the Shareholder is party.

3.6.3 Except as provided in Schedule 3.6, neither the execution, delivery and performance of this Agreement by the Company or the Shareholder, nor the consummation by the Company or the Shareholder of the transactions contemplated hereby, nor compliance by the Company or the Shareholder with any of the terms or provisions hereof or thereof, will result the cancellation or termination of, or give any party the right to cancel, modify or amend: (i) any security clearance held by the Company, the Shareholder or any employee of the Company and used or useful in connection with its business or (ii) any agreement for the sale of materials, products, services or supplies or qualification authorizing or permitting the Company to sell materials, products, services or supplies or qualification to any person.

3.7 CONSENTS AND APPROVALS. Except as provided in Schedule 3.7, the execution, delivery and performance of this Agreement by the Company or the Shareholder does not require any consent, approval, authorization or permit of, or filing with or notification to, any Governmental Authority or with any third party. Neither the Company nor the Shareholder is aware of any reason why the approvals, consents and waivers referred to herein should not be obtained.



3.8 ABSENCE OF CERTAIN PAYMENTS. Neither the Company, nor any director, officer, agent, employee or other person acting on behalf of the Company, has used any funds of the Company for unlawful contributions, gifts, entertainment or other unlawful expenses relating to political activity, or made any direct or indirect unlawful payments to government officials or employees from corporate funds, or established or maintained any unlawful or unrecorded funds, or violated any provisions of the Foreign Corrupt Practices Act of 1977 or any rules or regulations promulgated thereunder.

3.9 COMPLIANCE. The Company has secured and maintained all material licenses, franchises, permits or authorizations for the lawful conduct of its business. The Company has in all material respects complied with and is not in material conflict with, or in default or material violation of, (i) any statute, code, ordinance, law, rule, regulation, order, writ, judgment, injunction or decree, published policies and guidelines of any Governmental Authority, applicable to the Company or by which any property or asset of the Company is bound or affected or (ii) any note, bond, mortgage, indenture, deed of trust, contract, agreement, lease, license, permit, franchise or other instrument or obligation to which the Company is a party or by which the Company or any property or asset of the Company is bound or affected.

3.10 TAXES AND TAX MATTERS.

3.10.1 The Company has filed all Tax Returns that it has been required to file since January 1, 1999. All such Tax Returns were correct and complete in all respects. All such Tax Returns were filed on the basis that the Company was an electing corporation under Subchapter S of the Code. All Taxes owed by the Company with respect to its income (whether or not shown on any Tax Return) have been paid. Except for taxes payable with respect to the Company's operation in 2004 that are not yet due and payable, all Taxes owed by the Shareholder with respect to the income of the Company (whether or not shown on any Tax Return) have been paid. The Company is not currently the beneficiary of any extension of time within which to file any Tax Return. The Company is not required to file Tax Returns in any jurisdiction where the Company does not file Tax Returns. There are no Liens on any of the assets of the Company that arose in connection with any failure (or alleged failure) to pay any Tax.

3.10.2 The Company has withheld and paid all Taxes required to be withheld or paid by the Company in connection with amounts paid or owing to any employee, independent contractor, creditor, shareholder, or other third party.

3.10.3 There is no dispute or claim concerning any Tax Liability of the Company either (i) claimed or raised by any authority in writing or (ii) as to which any of the Company and the directors and

officers (and employees responsible for Tax matters) of the Company has knowledge based upon personal contact with any agent of such authority. The Company has delivered to the Buyer correct and complete copies of all federal income Tax Returns filed by the Company since January 1, 1999, none of which have been the subject of any examination reports, or statements of deficiencies.



3.10.4 The Company has not waived any statute of limitations in respect of Taxes or agreed to any extension of time with respect to a Tax assessment or deficiency.

3.10.5 The Company elected as of 1972 to report its taxes under Subchapter S of the Code and such election remains in effect as of the date of this agreement.

3.11 ASSETS. The Company has good and marketable title to all of the assets it purports to own, and owns all of such assets free and clear of any Liens, other than (i) statutory liens securing current taxes and other obligations that are not yet delinquent, (ii) minor imperfections of title and encumbrances that do not materially detract from or interfere with the present use or value of such properties and (iii) liens disclosed in Schedule 3.11. The assets that the Company owns are all of the assets necessary for the continued conduct of the Company's business in the manner in which it has heretofore been conducted. The Company does not have any leased property (real or personal) except as disclosed in Schedule 3.11.

3.12 CONDITION OF ASSETS. All of the assets of the Company, including any assets held under leases or licenses, will be in the same condition and repair as of the date of this Agreement, ordinary wear and tear excepted.

3.13 EQUITY INVESTMENTS. Except as set forth in Schedule 3.13, the Company does not currently own any capital stock or other proprietary interest, directly or indirectly, in any corporation, association, trust, partnership, joint venture or other entity.

3.14 FINANCIAL STATEMENTS. The balance sheets and related statements of operations and cash flows of the Company (the "COMPANY FINANCIAL STATEMENTS") prepared by the Shareholder's Accountant as of and for the periods ended December 31, 2003 and 2002, and the internally prepared balance sheet and related statement of operations of the Company as of and for the period ended March 31, 2004 (the "INTERIM FINANCIAL STATEMENTS"), that are included as Exhibit 3.14 fairly present in all material respects the financial position of the Company as at such dates and the results of its operations for the periods then ended, subject to, in the case of the Interim Financial Statements, adjustments required in the normal course for the three months ended March 31, 2004. Since the date of the Interim Financial Statements, there has been no Material Adverse Change. To the knowledge of the Shareholder based upon his general familiarity with the financial condition and results of operations of the Company and upon his review of the preliminary drafts of the internally prepared balance sheet and related statement of operations of the Company as of and for the nine-month period ended March 31, 2004, the unaudited financial statements of the Company for that nine-month period, consistently applied from period to period, will reflect EBIT of not less than $4,500,000 and net worth as of March 31, 2004 of not less than $6,000,000, except that it is understood that the net worth as reflected in the financial statements shall be reduced by (a) approximately $1.3 million for valuation of molds, and (b) sums paid between January 1, 2004 and March 31, 2004 in respect of the Shareholder's Subchapter S Tax Liabilities. Since March 31, 2004, the Company has made no distributions to the Shareholder, except for taxes.



3.15 ABSENCE OF UNDISCLOSED LIABILITIES. Except as set forth in the Company Financial Statements, the Company has no liabilities of any nature (matured or unmatured, accrued, fixed or contingent, including, without limitation, any liabilities for unpaid taxes), except as have accrued in the ordinary course of business from the date of the Interim Financial Statements to the date of this Agreement and to the Closing Date.

3.16 ABSENCE OF CERTAIN CHANGES OR EVENTS. Since the date of the Interim Financial Statements, except as set forth in Schedule 3.16, the Company has conducted its business only in the ordinary course and in manners consistent with past practice and there has not been (i) either individually or in the aggregate, any change or effect that is or would be materially adverse to the business, assets, liabilities, financial condition or results of operations of the Company, (ii) any material damage, destruction or loss with respect to any property or asset of the Company, (iii) any change by the Company in its accounting methods, principles or practices, other than changes required by applicable law or GAAP or regulatory accounting as concurred in by the Company's independent accountants, (iv) any entry by the Company into any contract or commitment of more than $25,000, (v) any material liability or obligation of any nature (whether accrued, absolute, contingent or otherwise and whether due or to become due), including without limiting the generality of the foregoing, liabilities as guarantor under any guarantees or liabilities for taxes, other than in the ordinary course of business consistent with past practice, (vi) any mortgage, pledge, lien or lease of any assets, tangible or intangible, of the Company with a value in excess of $25,000 in the aggregate, (vii) any acquisition or disposition of any assets or properties having a value in excess of $25,000, or any contract for any such acquisition or disposition entered into, or (viii) any lease of real or personal property entered into, other than in the ordinary course of business consistent with past practice.

3.17 NO BONUSES OR OTHER PAYMENTS TO EMPLOYEES, DIRECTORS, OFFICERS. Since December 31, 2003, except in the ordinary course of business or as set forth in Schedule 3.17, the Company has not (i) paid or agreed to pay any bonus or any other increase in the compensation payable or to become payable or (ii) granted or agreed to grant any bonus, severance or termination pay, or entered into any contract or arrangement to grant any bonus, severance or termination pay, to any director, officer or employee of the Company. Except as set forth in Schedule 3.17, the Company has made no severance or similar commitment to any of its employees. Without limiting the generality of the preceding sentences, the Company has not paid or agreed to pay any payments that would result, either individually or in aggregate, in the payment of an "excess parachute payment" within the meaning of Section 208G of the Code or that would result, either individually or in the aggregate, in payments that would be nondeductible pursuant to Section 162(m) of the Code.

3.18 ABSENCE OF LITIGATION. Neither the Company nor the Shareholder is a party to any, nor are there any pending, or to the knowledge of the Company or the Shareholder, threatened legal, administrative, arbitral or other claims, actions, proceedings or investigations of any material nature, against the Company or any property or asset of the Company, before any Governmental Authority and no facts or circumstances have come to the Company's or the Shareholder's attention which have caused it to believe that a material claim, action, proceeding or investigation against or affecting the Company could reasonably be expected to occur. Neither the Company, nor any property or asset of the Company, is subject to any order, writ, judgment, injunction, decree,



determination or award which restricts its ability to conduct business in any area in which it presently does business or has or could reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect.

3.19 EMPLOYEE BENEFITS. Attached as Exhibit 3.19 is the Company's "Employee Manual" detailing the employee benefits established by the Company for its employees. Except as set forth in Schedule 3.19, the Company does not currently maintain any pension, profit sharing, retirement, deferred compensation, welfare, insurance, disability, bonus, vacation pay, severance pay or other similar plans, programs or agreements, or any personnel policy, whether reduced to writing or not, relating to any persons employed by the Company (as defined for purposes of Section 414(b), (c) and (m) of the Code, a "PLAN") and has no liability under ERISA or any other law or regulation relating to any Plans. The Company has never been obligated to contribute to any "multi-employer plan," as defined in Section 3(37) of ERISA.

3.20 WORK STOPPAGES. No work stoppage involving the Company is pending or, to the knowledge of the Company, threatened. The Company is not involved in, or, to the knowledge of the Company, threatened with or affected by, any dispute, arbitration, lawsuit or administrative proceeding relating to labor or employment matters which might reasonably be expected to interfere in any

material respect with the respective business activities of the Company. No employees of the Company are represented by any labor union, and, to the knowledge of the Company, no labor union is attempting to organize employees of the Company.

3.21 INTELLECTUAL PROPERTY RIGHTS.

3.21.1 The Marks that are listed in Schedule 3.21 are the only trademarks, service marks, trade names, trade dress and copyrights used or proposed to be used by the Company in its business. To the Company's knowledge, the Company is the sole and exclusive owner of such Marks, free and clear of all Liens and the use by the Buyer of such Marks will not infringe upon any trademark, service mark, trade name, trade dress or copyright belonging to any other Person.

3.21.2 The Patents that are listed in Schedule 3.21 are the only patents and patents applications used or proposed to be used by the Company in its business. To the Company's knowledge, the Company is the sole and exclusive owner of such Patents and patent applications, free and clear of all Liens and the use by the Buyer of such Patents will not infringe upon any patent or patent application belonging to any other Person.

3.21.3 The Company has not misappropriated any of the Intellectual Property from any third Person and the Company has taken all reasonable security measures to protect and maintain the secrecy, confidentiality and value of any Intellectual Property owned by the Company and used in its business.

3.21.4 No other Person has any right, title or interest in any Patent, Trade Secret or Mark, which has arisen out of the activities by the Company or on behalf of the Company by any of its current or former officers, directors, employees, consultants or agents or any holder of securities of the Company.



3.22 PROPRIETARY INFORMATION OF THIRD PARTIES. To the knowledge of the Company, no third party has claimed that the Company or any person employed by or otherwise providing services to the Company has (i) violated any of the terms or conditions of his or her employment, non-competition, non-disclosure or inventions agreement with such third party, (ii) disclosed or utilized any trade secret of such third party or (iii) interfered in the employment relationship between such third party and any of its present or former employees.

3.23 ENVIRONMENTAL LIABILITY. Except as disclosed in Schedule 3.23, the Company is in full compliance with all Environmental Laws (as defined below). There is no litigation or other proceeding seeking to impose, or that could reasonably result in the imposition on the Company of any liability arising under any of the Environmental Laws, pending or, to the knowledge of the Company, threatened or unasserted but considered probable of assertion and which if asserted would have at least a reasonable probability of an unfavorable outcome against the Company; the Company does not have any knowledge of any reason for any such potential litigation that would impose any such liability; and the Company is not subject to any agreement, order, judgment, decree, or memorandum by or with any Governmental Authority or third party imposing any such liability. For the purposes of this Agreement, the term "Environmental Laws" shall mean any Federal, state or local law or ordinance or regulation pertaining to the protection of human health or the environment, including, without limitation, the Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. Sections 9601, et seq., the Emergency Planning and Community Right-to-Know Act, 42 U.S.C. Sections 11001, et seq., and the Resource Conservation and Recovery Act, 42 U.S.C. Sections 6901 et seq.

3.24 COMPETING INTERESTS. Except as set forth in Schedule 3.24, neither the Company, nor any director or officer of the Company, or any immediate family member of any of the foregoing (i) owns, directly or indirectly, an interest in any entity that is a competitor, customer or supplier of the Company or that otherwise has material business dealings with the Company or (ii) is a party to, or otherwise has any direct or indirect interest opposed to the Company under, any agreement or other business relationship or arrangement material to the Company, provided that the foregoing will not apply to any investment in

publicly traded securities constituting less than Three Percent (3%) of the outstanding securities in such class

3.25 NO GOVERNMENTAL CONSENT OR APPROVAL REQUIRED. Except as set forth in Schedule 3.7, no authorization, consent, approval or other order of, declaration to, or filing with, any Governmental Authority or body is required for or in connection with the valid and lawful authorization, execution, delivery and performance by the Company of this Agreement.

3.26 INVESTMENT BANKER. Except for Oppenheimer & Co., Inc., no broker, finder or investment banker, is entitled to any brokerage, finder's or other fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of the Company.

3.27 COMPETING INTERESTS. Neither the Shareholder, nor or any immediate family member of any of the foregoing (i) owns, directly or indirectly, an interest in any entity that is a competitor, customer or supplier of the Company or that otherwise has material business dealings with the Company or (ii) is a party to, or otherwise has any direct or indirect interest opposed to the



Company under, any agreement or other business relationship or arrangement material to the Company, provided that the foregoing will not apply to any investment in publicly traded securities constituting less than three percent (3%) of the outstanding securities in such class.

3.28 DISCLOSURE. No representation or warranty of the Company or the Shareholder contained in this Agreement, and no statement contained in any Schedule, certificate, list or other writing furnished to the Buyer pursuant to the provisions hereof, contains or will contain any untrue statement of a material fact or omits or will omit to state a material fact necessary in order to make the statements herein or therein, in light of the circumstances in which they are made, not misleading. No information believed by the Company or the Shareholder to be material to the Purchase/Sale and which is necessary to make the representations and warranties herein contained, taken as a whole, not misleading, to the knowledge of the Company or the Shareholder, has been withheld from, or has not been delivered in writing to, the Buyer.

## ARTICLE IV

## REPRESENTATIONS AND WARRANTIES OF BUYER

The Buyer represents and warrants to the Company and the Shareholder that, except as set forth in the appropriately numbered Disclosure Schedules delivered by the Buyer to the Company and the Shareholder:

4.1 ORGANIZATION. The Buyer is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware and has all requisite corporate power and authority to own and lease its properties, to carry on its business as presently conducted and as proposed to be conducted and to carry out the transactions contemplated hereby.

4.2 AUTHORITY. The Buyer has full corporate power and authority (i) to execute and deliver all documents to be executed by the Buyer in connection with or pursuant to this Agreement; (ii) to perform its obligations under this Agreement and (iii) to consummate the transactions contemplated by this Agreement. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly approved by the Board of Directors of the Buyer and no other corporate proceedings on the part of the Buyer are necessary to approve this Agreement or to consummate the transactions contemplated hereby. This Agreement has been duly and validly executed and delivered by the Buyer and constitute valid and binding obligations of the Buyer, enforceable against the Buyer in accordance with their respective terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, moratorium and other similar laws of general applicability relating to or affecting creditors' rights generally and by the application of general principles of equity.

4.3 NO CONFLICT. Neither the execution, delivery and performance of this Agreement by the Buyer, nor the consummation by the Buyer of the transactions contemplated hereby, nor compliance by the Buyer with any of the

terms or provisions hereof, will (i) conflict with, violate or result in a breach of any provision of the Organizational Documents of the Buyer, (ii) conflict with, violate or result in a breach of any statute, code, ordinance, rule, regulation, order, writ, judgment, injunction or decree applicable to the Buyer, or by which any property or asset of the Buyer is bound or affected, or (iii) conflict with, violate or result in a breach of any provisions of or the



loss of any benefit under, constitute a default (or an event, which, with notice or lapse of time, or both, would constitute a default) under, or give to others any right of termination, amendment, acceleration or cancellation of, or result in the creation of a Lien, pledge, security interest, charge or other encumbrance on any property or asset of the Buyer pursuant to any of the terms, conditions or provisions of any note, bond, mortgage, indenture, deed of trust, contract, agreement, lease, license, permit, franchise or other instrument or obligation to which the Buyer is a party, or by which the Buyer is bound or affected.

4.4 CONSENTS AND APPROVALS. The execution, delivery and performance of this Agreement by the Buyer does not require any consent, approval, authorization or permit of, or filing with or notification to any Governmental Authority or with any third party, except for filings with the Securities and Exchange Commission and the Nasdaq Stock Market. The Buyer is not aware of any reason why the approvals, consents and waivers of Governmental Authorities referred to herein should not be obtained.

4.5 DISCLOSURE. No representation or warranty contained in this Agreement, and no statement contained in any Schedule, certificate, list or other writing furnished to the Company or the Shareholder pursuant to the provisions hereof, contains or will contain any untrue statement of a material fact or omits or will omit to state a material fact necessary in order to make the statements herein or therein, in light of the circumstances in which they are made, not misleading. No information believed by the Buyer to be material to the Purchase/Sale and which is necessary to make the representations and warranties herein contained, taken as a whole, not misleading, to the knowledge of the Buyer, has been withheld from, or has not been delivered in writing to, the Company.

## ARTICLE V

## COVENANTS OF THE PARTIES

5.1 LEGAL CONDITIONS TO PURCHASE/SALE. Each of the Buyer, the Shareholder and the Company shall use his or its commercially reasonable best efforts (i) to take, or cause to be taken, all actions necessary, proper or advisable to comply promptly with all legal requirements which may be imposed on such party with respect to the Purchase/Sale and, subject to the conditions set forth in Article V, to consummate the transactions contemplated by this Agreement and the Escrow Agreement and (ii) to obtain (and to cooperate with the other party to obtain) any consent, authorization, order or approval of, or any exemption by, any Governmental Authority and any other third party which is required to be obtained in connection with the Purchase/Sale and the other transactions contemplated by this Agreement.

5.2 ADDITIONAL AGREEMENTS. In case at any time after the Closing any further action is necessary or desirable to carry out the purposes of this Agreement, or to vest the Buyer with full title to the Company Common Stock, each party to this Agreement shall take all such necessary action as may be reasonably requested by the Buyer.

5.3 ORDINARY COURSE OPERATIONS. From the date of this Agreement until the Closing, the Shareholder shall cause the Company to conduct its business only in the ordinary course and in a manner consistent with prior practices. Without limiting the generality of the foregoing, from the date of this



Agreement until the Closing, the Shareholder shall not and shall not permit the Company to directly or indirectly: (i) issue any new shares of Company Common Stock, cause or permit any sale, assignment, transfer or conveyance of any

outstanding Company Common Stock, or sell, assign, transfer or convey any of the Company's assets (other than sales of its products in the ordinary course of business); (ii) solicit any offers for, respond to any unsolicited offers for, or enter into or conduct any negotiations in respect of any of the foregoing; or (iii) in any way assist or encourage any person in connection with any proposed acquisition of any Company Common Stock or any assets of the Company (other than sales of its products in the ordinary course of business). The Buyer acknowledges that the Company, prior to the Closing, will authorize and pay salaries to the Shareholder in the ordinary course and will authorize and pay distributions to the Shareholder of an amount reasonably estimated to fund the Subchapter S Tax Liabilities of the Shareholder for the income of the Company for 2003 and 2004, on the dates, in the amounts and in respect of the periods set forth in Schedule 5.3 hereto. The Shareholder agrees that from the date of this Agreement to the Closing, the Shareholder shall not cause or permit the Company to make any payments to the Shareholder other than salaries in the ordinary course, distributions to fund the liabilities of the Shareholder for taxes with respect to the Company's taxable income and expense and similar reimbursements in the ordinary course.

5.4 POST-CLOSING TAX MATTERS. The following provisions shall govern the allocation of responsibility as between the Buyer and the Shareholder for certain tax matters following the Closing Date:

5.4.1 The Shareholder shall prepare or cause to be prepared and file or cause to be filed all Tax Returns for the Company for the years ended December 31, 2003 and 2004 and all periods ending on or prior to such dates that are filed after the Closing Date. The Buyer shall provide the Shareholder with all access reasonably required to the financial records of the Company to prepare such Tax Returns. The Shareholder shall permit the Buyer to review and approve of each such Tax Return described in the preceding sentence prior to filing, which approval shall not be unreasonably withheld or delayed. The Shareholder confirms that the amounts specified in Schedule 5.3 have prior to the date of this Agreement been distributed by the Company to the Shareholder to fund the Shareholder's Subchapter S Tax Liabilities with respect to the income realized by the Company in 2003 and 2004. The Shareholder agrees that any further distributions that are made to him by the Company from the date of this Agreement to the Closing will be limited to the amounts that the Shareholder estimates will be necessary, when added to the amounts described in Schedule 5.3, to fully fund the Shareholder's Subchapter S Tax Liabilities for all of the taxable income realized by the Company for the full year ended December 31, 2003 and for the period from January 1, 2004 through and including the Closing Date. If, based upon the Tax Returns prepared for the Company by the Shareholder and approved by the Buyer for the years 2003 and 2004, the amounts payable by the Shareholder as Subchapter S Tax Liabilities for the years 2003 and 2004 are more or less than the sum of all distributions made by the Company to the Shareholder to fund such Subchapter S Liabilities, then (i) if the amounts distributed exceed such Subchapter S Liabilities, then the Shareholder shall



immediately refund such excess to the Company and (ii) if the amounts distributed are less than such Subchapter S Liabilities, then the Company shall immediately make a distribution of such deficiency to the Shareholder. In either instance, the amount paid by or to the Shareholder shall be recorded as a correcting adjustment to the amounts distributed by the Company to the Shareholder, while he continued to be the holder of the Company Common Stock. Any dispute regarding the computation of the Subchapter S Tax Liabilities of the Shareholder shall be resolved in the manner described in Section 11.1. The amount payable under this Section shall be in addition to all other amounts payable by the Buyer under this Agreement. Except as expressly provided in this Section, the Shareholder shall be solely responsible for the payment of Taxes due under such Tax Returns (whether or not shown in those Tax Returns) and shall indemnify and hold the Company and the Buyer harmless from any liability for any income Taxes payable with respect to the income realized by the Company prior to the Closing Date. The Shareholder shall be responsible for the payment of 2004 Taxes only on the Company income earned and computed up to the Closing Date.

5.4.2 The Buyer shall cause the Company to prepare or cause to be prepared and file or cause to be filed all Tax Returns for the Company for all periods ending after the Closing Date.

5.4.3 If requested by the Buyer by written notice delivered within 180 days following the Closing Date, the Buyer, the Company and, if required, the Shareholder shall sign and file Form 8023 providing for an election under Section 338(h)(10) of the Code with respect to the transactions contemplated by this Agreement and the Shareholder shall cooperate in good faith with Buyer in making that election. As a condition to the agreement and cooperation of the Shareholder in making the election under Section 338(h)(10), Buyer agrees to promptly reimburse Shareholder for all additional federal and state income tax incurred by Shareholder (or the Company prior to the Closing Date) as a result of making that election. The Shareholder shall cause the Shareholder's Accountant, as soon as reasonably possible after the Shareholder receives the written request from the Buyer regarding an election under 338(h)(10), to prepare and to provide to the Buyer a written determination of all such additional taxes and such amount shall be payable by the Buyer to the Shareholder not later than twenty (20) days before such taxes will be payable by the Shareholder. Any dispute regarding the computation of the taxes payable by the Shareholder as a result of the election under Section 338(h)(10) shall resolved in the manner described in Section 10.1. The amount payable under this Section shall be in addition to all other amounts payable by the Buyer under this Agreement.

5.4.4 Buyer, the Company and the Shareholder shall cooperate fully, as and to the extent reasonably requested by the other party, in connection with the filing of Tax Returns pursuant to this Section and any audit, litigation or other proceeding with respect to Taxes, with the Shareholder having the right and responsibility to conduct and resolve (and to indemnify the Buyer and the Company from any liability with respect to) the audit of any returns filed pursuant to Section



5.4.1 and with the Buyer having the right and responsibility to conduct and resolve (and to indemnify the Shareholder from any liability with respect to) the audit of any returns filed pursuant to Section 5.4.2. Such cooperation shall include the retention and (upon the other party's request) the provision of records and information which are reasonably relevant to any such audit, litigation or other proceeding and making employees available on a mutually convenient basis to provide additional information and explanation of any material provided hereunder. The Company and the Shareholder agree (i) to retain all books and records with respect to tax matters pertinent to the Company relating to any tax period beginning before the Closing Date until the expiration of the statute of limitations (and, to the extent notified by Buyer, any extensions thereof) of the respective tax periods, and to abide by all record retention agreements entered into with any taxing authority, and (ii) to give the other party reasonable written notice prior to transferring, destroying or discarding any such books and records and, if the other party so requests, the Company and the Shareholder, as the case may be, shall allow the other party to take possession of such books and records.

5.4.5 All transfer, documentary, sales, use, stamp, registration and other such Taxes and fees (including any penalties and interest) incurred in connection with this Agreement shall be paid when due by the Person to whom or which such Taxes are assessed under applicable law and each Person will, at such Person's own expense, file all necessary Tax Returns and other documentation with respect to all such transfer, documentary, sales, use, stamp, registration and other Taxes and fees, and, if required by applicable law, all other Persons will, and will cause its affiliates to, join in the execution of any such Tax Returns and other documentation.

5.5 POST-CLOSING INSURANCE COVERAGE. The Shareholder, Buyer and the Company agree that at all times after the Closing Date, and until the Shareholder is paid all amounts due under this Agreement (and/or until any and

all disputes are fully and finally resolved between the parties as to the amounts to be paid to Shareholder), the Company shall maintain insurance coverages in the same types and amounts as are presently being maintained by the Company, as of the date of this Agreement.

## ARTICLE VI

## CONDITIONS TO CLOSING

6.1 CONDITIONS TO OBLIGATIONS OF ALL PARTIES. The respective obligations of each party under this Agreement shall be subject to the fulfillment at or prior to the Closing of the following conditions, none of which may be waived:

6.1.1 No order, injunction or decree (whether temporary, preliminary or permanent) issued by federal or state governmental authority or other agency or commission or federal or state court of competent jurisdiction or other legal restraint or prohibition preventing the consummation of the Purchase/Sale or any of the other



transactions contemplated by this Agreement shall be in effect and no proceeding initiated by any governmental entity seeking an such injunction, decree, restraint or prohibition shall be pending. No statute, rule, regulation, order, injunction or decree (whether temporary, preliminary or permanent) shall have been enacted, entered, promulgated or enforced by any federal or state governmental authority or other agency or commission or federal or state court of competent jurisdiction, which prohibits, restricts or makes illegal the consummation of the Purchase/Sale or any of the other transactions contemplated by this Agreement.

6.1.2 Any filings with and notifications to, and all approvals and authorizations of, third parties (including, without limitation, governmental entities and authorities) required for the consummation of the transactions contemplated by this Agreement shall have been made or obtained and all such approvals and authorizations (the "REQUISITE REGULATORY APPROVALS") obtained shall be effective and shall not have been suspended, revoked or stayed by action of any governmental entity or authority.

6.2 CONDITIONS TO OBLIGATIONS OF THE BUYER. The obligations of the Buyer under this Agreement are, at the option of the Buyer, subject to the fulfillment of all of the following conditions on the dates specified below:

6.2.1 The Company and the Shareholder shall have demonstrated to the Buyer's satisfaction that (i) during the nine-month period ending March 31, 2004, the Company shall have had EBIT of not less than $4,500,000; (ii) during the nine-month period ending June 30, 2004, the Company shall have had EBIT of not less than $6,000,000; (iii) as of March 31, 2004, the Company's net worth shall not be less than $6,000,000, except that it is understood that the net worth reflected as in the financial statements shall be reduced by (a) approximately $1.3 million for valuation of molds, and (b) sums paid between January 1, 2004 and March 31, 2004 in respect of Subchapter S tax distributions, and (iv) since March 31, 2004 through March 31, 2004, the Company has been operated in the ordinary course consistent with past practice.

6.2.2 Since January 1, 2004, there shall not have occurred any distributions to the shareholders of the Company other than the distributions set forth in Schedule 5.4.1 hereto.

6.2.3 As of the Closing, the Company shall not, in the Buyer's sole judgment, have suffered any Material Adverse Change.

6.2.4 As of the Closing, the Shareholder shall have delivered to the Buyer a written notice confirming that each of the conditions to the Shareholder's obligations under this Agreement that are specified in Section 6.3 have been satisfied or waived by the Shareholder.

6.2.5 As of the Closing, each of the representations and warranties of the Shareholder and the Company in this Agreement shall be true and correct in all material respects, in each case as of the date of this Agreement, as applicable, and (except to the extent such representations and warranties speak as of an earlier date) as of the Closing.

6.2.6 On or prior to the Closing, the Shareholder and the Company shall have performed in all material respects all obligations and complied in all material respects with all agreements or covenants of the Shareholder and the Company to be performed or complied with by the Shareholder or the Company at or prior to the Closing under this Agreement.

6.2.7 On or prior to the Closing, the Company shall have entered into employment agreements in the forms of Exhibits 6.2.7(a) and 6.2.7(b) with the following Persons to continue to perform services for the Company following the Closing Date: (i) Arthur G. Schreiber as a part-time employee for a term of two years; and (ii) John R. Nehmens as a full-time employee for a term of five years.

6.2.8 On or prior to the Closing, the Buyer shall have received the opinion of M. Neil Cummings, Esq., dated as of the Closing Date, with respect to the matters set forth in Exhibit 6.2.8.

6.2.9 As of the Closing, none of the Requisite Regulatory Approvals shall impose any term, condition or restriction upon the Buyer or any of its subsidiaries that the Buyer reasonably determines would materially impair the value of the Company to the Buyer or be materially burdensome (a "BURDENSOME CONDITION").

6.2.10 As of the Closing, neither the Company nor any Shareholder shall have taken any action or made any payments that would result, either individually or in the aggregate, in the payment of an "excess parachute payment" within the meaning of Section 280G of the Code or that would result, either individually or in the aggregate, in payments that would be nondeductible pursuant to Section 162(m) of the Code.

6.3 CONDITIONS TO OBLIGATIONS OF THE COMPANY AND THE SHAREHOLDER. The obligations of the Company and the Shareholder under this Agreement are, at the option of the Company and the Shareholder, subject to the fulfillment or written waiver by the Shareholder of all of the following conditions on or before the dates specified below:

6.3.1 As of the Closing, the Buyer shall have delivered to the Shareholder a written notice confirming that each of the conditions to the Buyer's obligations under this Agreement that are specified in Section 6.2 have been satisfied or waived by the Buyer.



6.3.2 As of the Closing, each of the representations and warranties of the Buyer in this Agreement shall be true and correct in all material respects as of the date of this Agreement, as applicable, and (except to the extent such representations and warranties speak as of an earlier date) as of the Closing.

6.3.3 On or prior to the Closing, the Buyer shall have performed in all material respects all obligations and complied in all material respects with all of the respective agreements or covenants to be performed or complied with by the Buyer at or prior to the Closing under this Agreement.

6.3.4 On or prior to the Closing, the Shareholder shall have received the opinion of Yaakov Har-Oz, Esq., dated as of the Closing Date, with respect to the matters set forth in Exhibit 6.3.4.

6.3.5 On or prior to the Closing, the Buyer shall have entered

into employment agreements with the Persons listed in Section 6.2.7 upon terms and conditions acceptable to such Persons and such agreements shall be in full force and effect.

6.3.6. As of the Closing, none of the Requisite Regulatory Approvals shall impose any Burdensome Condition upon the Shareholder.

ARTICLE VII

THE CLOSING

7.1 CLOSING. Subject to the terms and conditions of this Agreement, the closing of the Purchase/Sale (the "CLOSING") will take place at 9:00 a.m. on July 30, 2004, or at such other date as is mutually approved by the Company and the Buyer (the "CLOSING DATE"), at the offices of the Buyer in New York, New York, or at such other time and place as the Buyer and the Shareholder may otherwise agree in writing. The Buyer's refusal to close on or prior to July 30 shall not constitute a breach of this Agreement, provided that for each week past July 30 that the Buyer does not close, the Buyer shall deposit an additional $125,000 with the Escrow Agent, with such sums (the "Additional Down Payment") to be added to the Escrow Consideration and deducted from the Closing Cash Consideration. Refusal by or failure of Buyer to close by August 16, 2004 shall constitute a breach of this Agreement and shall entitle the Shareholder to receive the Down Payment and the Additional Down Payment in accordance with the terms of the Escrow Agreement.

7.2 DELIVERIES AT CLOSING. Subject to satisfaction of the conditions precedent set forth in this Agreement, at the Closing the parties will deliver the following:

7.2.1 The Buyer shall pay to the Shareholder by wire transfer of funds, to an account to be specified by the Shareholder in writing and transmitted to the Buyer as set forth in Section 11.3 hereof at least two (2) business days prior to the Closing Date, the Closing Cash Consideration specified in Section 2.3.2.



7.2.2 The Buyer shall pay to the Escrow Agent by wire transfer of funds, to an account to be specified by the Escrow Agent in writing and transmitted to the Buyer as set forth in Section 11.3 hereof at least two (2) business days prior to the Closing Date, the Escrow Consideration specified in Section 2.3.3.

7.2.3 The parties shall exchange all other documents that the Company or the Buyer may reasonably request be delivered at the Closing so as effectively to consummate the transactions contemplated hereby.

ARTICLE VIII

INDEMNIFICATION

8.1 INDEMNIFICATION OF THE BUYER. Subject to the limitations in other Sections of this Article VIII, the Shareholder will indemnify and hold Buyer harmless from any and all Liabilities, obligations, claims, contingencies, damages, costs and expenses, including all court costs and reasonable attorney fees (collectively, "LOSSES"), that Buyer suffers or incurs as a result of or relating to:

8.1.1 The breach of any material representation or warranty made by the Company or the Shareholder in this Agreement or pursuant hereto; or

8.1.2 The breach of any material covenant or agreement of the Company or the Shareholder under this Agreement.

The sole and exclusive recourse of the Buyer for any Losses within the scope of this Section 8.1 shall be to seek and secure indemnification from the Shareholder in accordance with the terms of this Article VIII.

8.2 INDEMNIFICATION OF THE SHAREHOLDER. Subject to the limitations in other Sections of this Article VIII, the Buyer will indemnify and hold the

Shareholder harmless from any and all Losses (as defined above), that any Shareholder suffers or incurs as a result of or relating to:

8.2.1 The breach of any representation or warranty made by the Buyer in this Agreement or pursuant hereto; or

8.2.2 The breach of any covenant or agreement of the Buyer under this Agreement.

The sole and exclusive recourse of the Shareholder for any Losses within the scope of this Section 8.2 shall be to seek and secure indemnification from the Buyer in accordance with the terms of this Article VIII.

8.3 SURVIVAL OF INDEMNIFICATION PROVISIONS. The rights of the Buyer and the Shareholder to indemnification under this Article VIII (each, as such, and "INDEMNIFIED PARTY") will survive the execution and delivery of this Agreement and the consummation of the transactions contemplated, subject to the limitation that the right of any Indemnified Party to indemnity for any Claim under this Article VIII shall terminate twenty-four (24) months after the Closing Date



unless, on or before such date, the Indemnified Party has delivered to the Indemnifying Party an Indemnity Notice with respect to that Claim in the time and manner specified in Section 8.4.

8.4 NOTICE OF CLAIM. The Indemnified Parties entitled to receive indemnification under this Article VIII agree to give prompt written notice (an "INDEMNITY NOTICE") to the party or parties from whom or which indemnification is sought (the "INDEMNIFYING PARTIES") upon the occurrence of any indemnifiable Loss or the assertion of any claim or the commencement of any action or proceeding in respect of which such a Loss may reasonably be expected to occur (a "CLAIM"). Such Indemnity Notice will include a reference to the event or events forming the basis of such Loss or Claim and the amount involved, unless such amount is uncertain or contingent, in which event the Indemnified Parties will give a later written notice when the amount becomes fixed.

8.5 THIRD PARTY CLAIMS. If a claim or demand by a third party is made against an Indemnified Party, and if such Indemnified Party intends to seek indemnity with respect thereto under this Article VIII or under any other provisions of this Agreement providing for indemnification, such Indemnified Party shall promptly deliver an Indemnity Notice to the Indemnifying Party setting forth such claims in reasonable detail. The Indemnifying Party shall have thirty (30) days after delivery of such Indemnity Notice to undertake, conduct and control, through counsel of its own choosing and at its own expense, the settlement or defense thereof, and the Indemnified Party shall cooperate with it in connection therewith; provided that the Indemnifying Party may not undertake, conduct and control such settlement or defense without the Indemnified Party's consent unless:

8.5.1 The Indemnifying Party acknowledges in writing its obligation to indemnify the Indemnified Party for any Losses relating thereto;

8.5.2 The Indemnifying Party provides reasonable evidence to the Indemnified Party of its financial ability to satisfy its indemnification obligations;

8.5.3 The suit, action, claim, liability or obligation does not seek to impose any liability or obligation upon the Indemnified Party other than for money damages;

8.5.4 The suit, action, claim, liability or obligation does not relate to the Indemnified Party's customer, supplier, employee, or sales representative relationships or otherwise implicate the ongoing operation of the Indemnified Party's business;

8.5.5 If the Indemnifying Party has assumed the defense, the Indemnified Party may participate in any such settlement or defense through counsel chosen by such Indemnified Party, and the fees and expenses of such counsel shall be borne by such Indemnified Party unless (i) the employment thereof has been specifically authorized by

the Indemnifying Party in writing, (ii) there exists a conflict of interest between the interests of the Indemnified Party and the Indemnifying Party or (iii) the Indemnifying Party has after a reasonable time failed to assume such defense and employ counsel;



8.5.6 If the Indemnifying Party has assumed the defense, then so long as the Indemnifying Party is reasonably contesting any such claim in good faith, the Indemnified Party shall not pay or settle any such claim without the written consent of the Indemnifying Party. Notwithstanding the foregoing, the Indemnified Party shall have the right to pay or settle any such claim without the consent of the Indemnifying Party; provided, that in such event it shall waive any right to indemnity therefor by the Indemnifying Party.

8.5.7 If the Indemnifying Party does not notify the Indemnified Party within thirty (30) days after the date of delivery of the Indemnity Notice that it elects to undertake the defense of the claim or is otherwise not permitted to assume such defense under the terms hereof, the Indemnified Party shall have the right to contest, settle or compromise the claim but shall not thereby waive any right to indemnity therefor pursuant to this Agreement. The Indemnifying Party shall not, except with the consent of the Indemnified Party, enter into any settlement that does not include as an unconditional term thereof the giving by the person or persons asserting such claim to all indemnified parties an unconditional release from all liability with respect to such claim or consent to entry of any judgment.

8.6. LIMITATION OF LIABILITY OF SHAREHOLDER. The liability of the Shareholder with respect to any Loss shall be limited as follows:

8.6.1 The Shareholder shall be required to indemnify and hold harmless the Buyer with respect to Losses only if and after the aggregate amount of all such Losses of Buyer exceed $250,000, at which point Shareholder will be liable for all Losses in excess of $50,000.

8.6.2 Except for Losses resulting from the breach by the Shareholder of any of the post-closing covenants in Sections 5.2 and 5.4, the liability of the Shareholder for Losses shall be limited to (i) twenty percent (20%) of the Closing Cash Consideration that has been paid by the Buyer to the Shareholder for the Company Common Stock for Losses resulting from claims that were first asserted during the period from the Closing to June 30, 2005, and (ii) ten percent (10%) of the Closing Cash Consideration that has been paid by the Buyer to the Shareholder for the Company Common Stock for Losses resulting from claims that were first asserted during the period from July 1, 2005 to June 30, 2006. There shall be no limit on the liability of the Shareholder for Losses resulting from the breach by the Shareholder of any of the post-closing covenants in Sections 5.2 and 5.4.

8.6.3 Any insurance payments or proceeds obtained by or for the benefit of the Company for the Losses described in Paragraphs 8.6.1 and 8.6.2, above, shall be credited against any liability of the



Shareholder with respect to any Loss(es), and the Shareholder's liability, if any, under this Paragraph 8.6 shall be reduced by the amount of any such insurance proceeds.

8.7 LIMITATION OF LIABILITIES OF THE BUYER. The liability of the Buyer with respect to any Losses shall be limited as follows:

8.7.1 The Buyer shall be required to indemnify and hold harmless the Shareholders with respect to Losses (other than Losses resulting from a breach by the Buyer of its commitment to pay the Purchase Price as required pursuant to Section 2.3) only if and after the aggregate amount of all such Losses of the Shareholders exceed $250,000, at which point Buyer will be liable for all Losses in excess of $50,000.

8.7.2 Except for Losses resulting from the breach by the Buyer of any of the post-closing covenants in Sections 2.3, 2.5, 5.1,5.2 and 5.4, the cumulative aggregate liability of the Buyer shall be limited to $1,000,000.

ARTICLE IX

TERMINATION AND EXPENSES

9.1 TERMINATION. This Agreement may be terminated and the Purchase/Sale and the other transactions contemplated by this Agreement may be abandoned at any time prior to the Closing, notwithstanding any requisite approval and adoption of this Agreement and the transactions contemplated in this Agreement by the Board of Directors of the Buyer and the Board of Directors and Shareholder of the Company:

9.1.1 By mutual written consent duly authorized by the Boards of Directors of the Buyer and the Company;

9.1.2 By either the Buyer or the Shareholder if the Closing shall not have occurred on or before July 30, 2004 or such later date as may be provided in Section 7.1 or as the parties may have agreed upon in writing; provided, however, that the right to terminate this Agreement under this Section 9.1.2 shall not be available to any party whose failure to fulfill any material obligation under this Agreement has been the cause of, or resulted in, the failure of the Closing to occur on or before such date; or

9.1.3 By either the Buyer or the Shareholder (provided that the terminating party is not then in material breach of any representation, warranty, covenant or other agreement contained herein) if there shall have been a material breach of any of the representations or warranties set forth in this Agreement on the part of the other party, which breach by its nature cannot be cured prior to the earlier of the Closing or within thirty (30) days following receipt by the breaching party of written notice of such breach from the other party hereto.



9.2 EFFECT OF TERMINATION; EXPENSES.

9.2.1 In the event of the termination of this Agreement pursuant to Section 9.1, this Agreement shall forthwith terminate, and there shall be no liability on the part of any party hereto, except as otherwise provided below.

9.2.2 If this Agreement is terminated as a result of any uncured breach of any material provision of this Agreement, then, the non-breaching party shall have the right to seek and secure recovery from the breaching party for (i) all damages permitted or required under applicable law as a result of such breach and (ii) all out-of-pocket costs and expenses (but in no event in an amount in excess of $50,000), including, without limitation, the reasonable fees and expenses of lawyers, accountants and investment bankers, incurred by such other party in connection with the entering into of this Agreement and the carrying out of any and all acts contemplated hereunder.

9.2.3 In addition to and not instead of the amounts referred to in Section 9.2.2 above, and except as otherwise provided in Section 9.2.4 below, if the Buyer fails to proceed to a Closing for any reason or for no reason, including without limitation for the reasons set forth in Sections 6.1 or 6.2 hereto, the Down Payment and any Additional Down Payment will be forfeited to the Shareholder, and the Escrow Agent will promptly transfer the Down Payment and any Additional Down Payment to the Shareholder.

9.2.4 In addition to and not instead of the amounts referred to in Section 9.2.2 above, if the Shareholder or the Company fail to proceed to a Closing for any reason or for no reason, including without

limitation for the reasons set forth in Sections 6.1 or 6.3 hereto, or if the Buyer fails to proceed to a Closing for reasons of Force Majeure, the Down Payment and any Additional Down Payment will be returned to the Buyer, and Escrow Agent will promptly transfer the Down Payment and any Additional Down Payment to the Buyer.

ARTICLE X

ARBITRATION

10.1 COMPUTATION OF THE PURCHASE PRICE. If either party disputes the amount of the Escrow Consideration payable to the Shareholder pursuant to Section 2.4, or the amount of the Earnout Consideration pursuant to Section 2.5, then such party shall deliver to the other a written notice describing the dispute which shall include a detailed description of the reasons and/or computations relevant to the dispute, and a demand for a revised amount of Escrow or Earn-Out Consideration (the "Dispute Notice"). If the party receiving the Dispute Notice does not within fifteen (15) days after receiving the Dispute Notice deliver to the other party a notice of objection to the Dispute Notice, which shall include a detailed description of the reasons and/or computations for the objection ("Objection to Dispute Notice"), then the revised amount of Escrow or Earn-Out Consideration set forth in the Dispute Notice shall be final and binding on both Buyer and Shareholder. If an Objection to Dispute Notice is timely delivered to the other party, then resolution of the issues set forth in the Dispute Notice and Objection to Dispute Notice shall be submitted to binding arbitration, in accordance with the provisions of Paragraph 10.2, below. In



connection with any Arbitration proceedings commenced to resolve any such dispute, the burden of proof shall be on the party who prepared the Objection to Dispute Notice.

10.2 ARBITRATION. Except as provided in Section 10.1 with respect to dispute over the computation of the Purchase Price, any dispute between the Buyer and the Shareholder with respect to this Agreement, including, without limitation, any dispute regarding computation of the Purchase Price or any Claim for indemnity under Article VIII, must be submitted to and resolved by arbitration through the American Arbitration Association (the "ASSOCIATION") within one hundred twenty (120) days of either party serving the other party with a written demand for Arbitration. The arbitration will be conducted through the offices of the Association in New York, New York. The arbitration will be implemented under the rules and procedures of the Association for commercial disputes. The decision of the arbitrator(s) will be conclusive and binding upon the Buyer and the Shareholder and will not be subject to any challenge or appeal. The decision of the arbitrator will be enforceable by either party through the order of any court of competent jurisdiction. The prevailing party in any Arbitration proceedings shall be entitled to recover its reasonable attorneys' fees, arbitration costs and other direct expenses.

ARTICLE XI

MISCELLANEOUS

11.1 INTEREST ON LATE PAYMENTS. If any amount payable by any party is not paid on or before its due date, including, without limitation, any amount determined to be payable based under the procedure specified in this Agreement, then the party obligated for that payment shall be obligated to pay such past due amount, plus interest on such amount at the rate of 7% per annum from the date such amount should have been paid pursuant to the applicable provision of this Agreement to the date of payment.

11.2 ASSIGNMENT. Except as provided below, neither this Agreement nor any of the rights, interests or obligations hereunder shall be assigned by any of the parties hereto (whether by operation of law or otherwise) without the prior written consent of the other parties. Subject to the preceding sentence, this Agreement will be binding upon, inure to the benefit of and be enforceable by the parties and their respective successors and assigns.

11.3 NOTICES. All notices, requests, claims, demands and other communications hereunder shall be in writing and shall be given (and shall be deemed to have been duly given upon receipt) by delivery in person, by email,

telecopy, telegram or telex or by registered or certified mail (postage prepaid, return receipt requested) to the respective parties at the following addresses (or at such other address for a party as shall be specified in a notice given in accordance with this Section 11.3):



If to the Company, to:

Armour of America, Incorporated
P.O. Box 1405
Beverly Hills, California 90213
Attention: Arthur G. Schreiber and John R. Nehmens
Telephone: (310) 532-0690
Fax: (310) 532-8696
E-mail: aoa@mindspring.com/jnehmens@mindspring.com

With a copy to:

Yaakov Har-Oz, Esq.
Vice President and General Counsel
Arotech Corporation
250 West 57th Street - Suite 310
New York, New York 10107
Telephone: 011-972-2-990-6623
Fax: 011-972-2-990-6688
E-mail: yaakovh@arotech.com

If to the Shareholder:

Arthur G. Schreiber
211 South Spalding Drive
Beverly Hills, California 90212
Telephone: (310) 277-3577
Fax: (310) 277-7957
E-mail: aoa@mindspring.com

With a copy to:

M. Neil Cummings, Esq.
11150 Olympic Boulevard - Suite 1050
Los Angeles, California 90064
Telephone: (310) 914-1849
Fax: (310) 914-1853
E-mail: mncassoc@aol.com



If to Buyer, to:

Arotech Corporation
250 West 57th Street - Suite 310
New York, New York 10107
Attention: Chairman and CEO
Telephone: (212) 258-3222
Fax: (212) 258-3281
E-mail: ehrlich@arotech.com

With a copy to:

Yaakov Har-Oz, Esq.
Vice President and General Counsel
Arotech Corporation
250 West 57th Street - Suite 310
New York, New York 10107
Telephone: 011-972-2-990-6623
Fax: 011-972-2-990-6688
E-mail: yaakovh@arotech.com

or at such other address for a party as shall be specified by like notice.

11.4 EXPENSES. Subject to the provisions of Section 9.2.2, each party hereto shall pay its own expenses in connection with the transactions contemplated hereby, whether or not they are completed; provided, however, that the Shareholder shall be required to reimburse the Company for (i) any fees or other expenses payable by the Company to Oppenheimer & Co., Inc., for services rendered in connection with the transactions contemplated by this Agreement and (ii) any expenses incurred by the Company in connection with the transactions contemplated by this Agreement. In the event of any conflict between this provision and the indemnification or termination provisions of this Agreement, the indemnification or termination provisions, as the case may be, shall control.

11.5 PUBLICITY. The parties will consult with respect to the appropriate public disclosure to be made with respect to the transactions contemplated hereby, and will make no such disclosure without reasonable notice to the other party prior to such disclosure. Notwithstanding the foregoing, the Company understands that the federal securities laws and applicable stock exchange listing agreements require Buyer to make certain disclosures of material events. Buyer will consult with the Company before providing any information about this Agreement or the Company in accordance with such requirements.

11.6 PARTIES IN INTEREST. This Agreement shall be binding upon and inure solely to the benefit of each party hereto, and nothing in this Agreement, express or implied, is intended to or shall confer upon any other person any right, benefit or remedy of any nature whatsoever under or by reason of this Agreement.



11.7 GOVERNING LAW AND DISPUTES. This Agreement shall be governed by, and construed and enforced in accordance with, the internal laws of the State of Delaware, without giving effect to its conflict of laws rules thereof. Disputes under this Agreement are to be resolved through arbitration as provided in Article X above. Any dispute with respect to the validity or applicability of the arbitration provisions of this Agreement or any other dispute that for any reason shall be claimed not to be subject to the arbitration provisions of this Agreement shall be litigated exclusively in the state or federal courts sitting in Wilmington, Delaware, and each of the parties hereby irrevocably consents to the exclusive jurisdiction of such courts and waives and agrees not to assert any objection to the jurisdiction or convenience thereof.

11.8 COUNTERPARTS. This Agreement may be executed in two (2) or more counterparts, all of which shall be considered one (1) and the same agreement and shall become effective when two (2) or more counterparts have been signed by each of the parties and delivered to the other parties, it being understood that all parties need not sign the same counterpart.

11.9 ENTIRE AGREEMENT. This Agreement constitutes the entire agreement among the parties hereto with respect to the subject matter hereof and supersedes all prior agreements and understandings, whether written or oral, among the parties, or any of them, in connection with such subject matter.

IN WITNESS WHEREOF, the parties have executed this Agreement under seal as of the day and year first above written.

COMPANY: ARMOUR OF AMERICA, INCORPORATED

By: _____
Arthur G. Schreiber, President

BUYER: AROTECH CORPORATION

By: _____

Robert S. Ehrlich, Chairman and CEO

SHAREHOLDER:

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ARTHUR G. SCHREIBER (113 shares)

EXHIBIT 31.1

CERTIFICATION

I, Robert S. Ehrlich, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arotech Corporation;

2. Based on my knowledge, this quarterly 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 quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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) for the registrant and we have:

   (a) designed such disclosure controls and procedures, or caused such disclosure control 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 quarterly report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this quarterly report based on such evaluation; and

   (c) disclosed in this quarterly 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 first fiscal quarter in the case of this quarterly 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 registrant's board of directors (or persons performing the equivalent function):

   (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 controls over financial reporting.

Dated: August 16, 2004

/s/ Robert S. Ehrlich

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

EXHIBIT 31.2

CERTIFICATION

I, Avihai Shen, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arotech Corporation;

2. Based on my knowledge, this quarterly 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 quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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) for the registrant and we have:

   (a) designed such disclosure controls and procedures, or caused such disclosure control 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 quarterly report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this quarterly report based on such evaluation; and

   (c) disclosed in this quarterly 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 first fiscal quarter in the case of this quarterly 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 registrant's board of directors (or persons performing the equivalent function):

   (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 controls over financial reporting.

Dated: August 16, 2004

/s/ Avihai Shen
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Avihai Shen, Vice President - Finance
(Principal Financial Officer)

EXHIBIT 32.1

WRITTEN STATEMENT

In connection with the Quarterly Report of Arotech Corporation (the "Company") on Form 10-Q for the quarterly period ended June 30, 2004 filed with the Securities and Exchange Commission (the "Report"), I, Robert S. Ehrlich, Chairman, President 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 to my knowledge, the 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 Report fairly presents, in all material respects, the consolidated financial condition of the Company and its subsidiaries as of the dates presented and the consolidated results of operations of the Company and its subsidiaries for the periods presented.

Dated: August 16, 2004

By: /s/ Robert S. Ehrlich
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Robert S. Ehrlich, Chairman, President and CEO
(Chief Executive Officer)

A signed original of this written statement required by Section 906 has been provided to Arotech Corporation and will be retained by Arotech Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and is not being filed as part of the Form 10-Q or as a separate disclosure document.

EXHIBIT 32.2

WRITTEN STATEMENT

In connection with the Quarterly Report of Arotech Corporation (the "Company") on Form 10-Q for the quarterly period ended June 30, 2004 filed with the Securities and Exchange Commission (the "Report"), I, Avihai Shen, 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 to my knowledge, the 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 Report fairly presents, in all material respects, the consolidated financial condition of the Company and its subsidiaries as of the dates presented and the consolidated results of operations of the Company and its subsidiaries for the periods presented.

Dated: August 16, 2004

By: /s/ Avihai Shen
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Avihai Shen, Vice President - Finance
(Chief Financial Officer)

A signed original of this written statement required by Section 906 has been provided to Arotech Corporation and will be retained by Arotech Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and is not being filed as part of the Form 10-Q or as a separate disclosure document.