

UNITED STATES  
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 March 31, 2005.

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.)

354 Industry Drive, Auburn, Alabama

36830

(Address of principal executive offices)

(Zip Code)

(334) 502-9001

(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  No

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares outstanding of the issuer's common stock as of April 30, 2005 was 80,105,018.

AROTECH CORPORATION

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AROTECH CORPORATION

ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED BALANCE SHEETS  
(U.S. Dollars)

<TABLE>  
<CAPTION>

	March 31, 2005	December 31, 2004
	----- (Unaudited)	-----
<S>	<C>	<C>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents .....	\$ 2,672,140	\$ 6,734,512
Restricted collateral deposits and restricted held to maturity securities	7,028,142	6,962,110
Available-for-sale marketable securities .....	135,147	135,568
Trade receivables (net of allowance for doubtful accounts in the amount of \$53,838 and \$55,394 as of March 31, 2005 and December 31, 2004, respectively) .....	6,419,665	8,266,880
Unbilled receivables .....	3,230,552	2,881,468
Other accounts receivable and prepaid expenses .....	1,426,548	1,339,393
Inventories .....	8,846,081	7,277,301
	-----	-----
Total current assets .....	29,758,275	33,597,232
	-----	-----
SEVERANCE PAY FUND .....	2,022,289	1,980,047
RESTRICTED SECURITIES AND DEPOSITS .....	4,000,000	4,000,000
PROPERTY AND EQUIPMENT, NET .....	4,491,995	4,600,691
OTHER INTANGIBLE ASSETS, NET .....	13,617,569	14,368,701
GOODWILL .....	39,669,212	39,745,516
	-----	-----
	\$93,559,340	\$98,292,187
	=====	=====

</TABLE>

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

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CONSOLIDATED BALANCE SHEETS  
(U.S. Dollars, except share data)

<TABLE>  
<CAPTION>

	March 31, 2005	December 31, 2004
	----- (Unaudited)	-----
<S>	<C>	<C>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables .....	\$ 4,023,471	\$ 6,177,546
Other accounts payable and accrued expenses .....	5,057,280	5,818,188
Current portion of promissory notes due to purchase of subsidiaries .....	13,510,325	13,585,325
Short-term bank loans and current portion of long-term loans .....	68,851	181,352
Deferred revenues .....	715,920	618,229
	-----	-----
Total current liabilities .....	23,375,847	26,380,640
<b>LONG TERM LIABILITIES</b>		
Accrued severance pay .....	3,543,312	3,422,951
Convertible debenture .....	2,147,346	1,754,803
Deferred revenues .....	141,790	163,781
Long-term note .....	10,319	20,891
Long-term portion of promissory note due to purchase of subsidiaries .....	982,738	980,296
	-----	-----
Total long-term liabilities .....	6,825,505	6,342,722
MINORITY INTEREST .....	128,658	95,842
<b>SHAREHOLDERS' EQUITY:</b>		
Share capital -		
Common stock - \$0.01 par value each;		
Authorized: 250,000,000 shares as of March 31, 2005 and December 31, 2004; Issued: 80,659,002 shares as of March 31, 2005 and 80,637,002 shares as of December 31, 2004; Outstanding - 80,103,669 shares as of March 31, 2005 and 80,081,669 shares as of December 31, 2004 .....	806,590	806,370
Preferred shares - \$0.01 par value each;		
Authorized: 1,000,000 shares as of March 31, 2005 and December 31, 2004; No shares issued and outstanding as of March 31, 2005 and December 31, 2004 .....	--	--
Additional paid-in capital .....	189,276,362	189,266,103
Accumulated deficit .....	(121,410,053)	(118,953,553)
Deferred stock compensation .....	(1,025,556)	(1,258,295)
Treasury stock, at cost (common stock - 555,333 shares as of March 31, 2005 and December 31, 2004) .....	(3,537,106)	(3,537,106)
Notes receivable from stockholders .....	(1,229,850)	(1,222,871)
Accumulated other comprehensive income .....	348,943	372,335

Total shareholders' equity .....	63,229,330	65,472,983
	\$ 93,559,340	\$ 98,292,187

</TABLE>

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

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CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)  
(U.S. Dollars, except share data)

<TABLE>  
<CAPTION>

	Three months ended March 31,	
	2005	2004
<S>	<C>	<C>
Revenues .....	\$ 10,387,445	\$ 7,182,254
Cost of revenues .....	6,371,874	4,557,220
Gross profit .....	4,015,571	2,625,034
Operating expenses:		
Research and development .....	414,678	463,506
Selling and marketing .....	1,158,820	1,021,084
General and administrative .....	3,356,412	2,088,136
Amortization of intangible assets .....	823,088	496,013
Total operating costs and expenses .....	5,752,998	4,068,739
Operating loss .....	(1,737,427)	(1,443,705)
Financial expenses, net .....	(468,855)	(1,078,545)
Loss before income taxes .....	(2,206,282)	(2,522,250)
Income tax income (expenses), net .....	(217,264)	4,907
Loss before minority interest in earnings of a subsidiary and income tax expenses	(2,423,546)	(2,517,343)
Minority interest in earnings of a subsidiary .....	(32,954)	(546)
Net loss .....	(2,456,500)	(2,517,889)
Deemed dividend to certain stockholders of common stock .....	--	(1,163,000)
Net loss attributable to common stockholders .....	\$ (2,456,500)	\$ (3,680,889)
Basic and diluted net loss per share from continuing operations .....	\$ (0.03)	\$ (0.04)
Basic and diluted net loss per share .....	\$ (0.03)	\$ (0.06)
Weighted average number of shares used in computing basic net loss per share .....	80,102,089	59,406,466

</TABLE>

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

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AROTECH CORPORATION

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
(U.S. Dollars, except share data)

<TABLE>  
<CAPTION>

	Common Stock		Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Treasury stock
	Shares	Amount				
<S>	<C>	<C>	<C>	<C>	<C>	<C>
BALANCE AT JANUARY 1, 2005 - .	80,637,002	\$ 806,370	\$ 189,266,103	\$ (1,258,295)	\$ (118,953,553)	\$ (3,537,106)
NOTE 1						
CHANGES DURING THE THREE-MONTH PERIOD ENDED MARCH 31, 2005						
Compensation related to						

non-recourse loan granted to shareholder .....	--	--	(11,500)	--	--	--
Issuance of shares to employees .....	10,000	100	(100)	--	--	--
Exercise of options by employees .....	12,000	120	14,880	--	--	--
Amortization of deferred stock compensation .....	--	--	--	232,739	--	--
Interest accrued on notes receivable from shareholders .....	--	--	6,979	--	--	--
Other comprehensive loss - foreign currency translation adjustment ..	--	--	--	--	--	--
Other comprehensive loss - unrealized gain on available for sale marketable securities ...	--	--	--	--	--	--
Net loss .....	--	--	--	--	(2,456,500)	--
Total comprehensive loss ...	--	--	--	--	--	--
BALANCE AT MARCH 31, 2005 - UNAUDITED	80,659,002	\$ 806,590	\$ 189,276,362	\$ (1,025,556)	\$ (121,410,053)	\$ (3,537,106)

<CAPTION>

	Notes receivable from shareholders	Accumulated other comprehensive income (loss)	Total comprehensive loss	Total
<S>	<C>	<C>	<C>	<C>
BALANCE AT JANUARY 1, 2005 - . NOTE 1	\$ (1,222,871)	\$ 372,335	\$ --	\$ 65,472,983
CHANGES DURING THE THREE-MONTH PERIOD ENDED MARCH 31, 2005				
Compensation related to non-recourse loan granted to shareholder .....	--	--	--	(11,500)
Issuance of shares to employees .....	--	--	--	--
Exercise of options by employees .....	--	--	--	15,000
Amortization of deferred stock compensation .....	--	--	--	232,739
Interest accrued on notes receivable from shareholders .....	(6,979)	--	--	--
Other comprehensive loss - foreign currency translation adjustment ..	--	(24,619)	(24,619)	(24,619)
Other comprehensive loss - unrealized gain on available for sale marketable securities ...	--	1,227	1,227	1,227
Net loss .....	--	--	(2,456,500)	(2,456,500)
Total comprehensive loss ...	--	--	\$ (2,479,892)	--
BALANCE AT MARCH 31, 2005 - UNAUDITED	\$ (1,229,850)	\$ 348,943		\$ 63,229,330

</TABLE>

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

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

<TABLE>

<CAPTION>

	Three months ended March 31,	
	2005	2004
<S>	<C>	<C>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss for the period before deemed dividend to certain stockholders of common stock	\$ (2,456,500)	\$ (2,517,889)
Adjustments required to reconcile net loss to net cash used in operating activities:		
Depreciation .....	298,110	236,408
Amortization of intangible assets .....	823,088	496,013
Amortization of compensation related to warrants issued to the holders of convertible debentures and beneficial conversion feature .....	392,543	921,684
Amortization of deferred expenses related to convertible debenture issuance .....	12,128	73,667
Amortization of capitalized research and development projects .....	30,710	9,163
Stock-based compensation due to shares granted and to be granted to consultants and shares granted as a donation .....	58,560	--
Stock based compensation due to options granted to employees and directors .....	98,639	--

Stock based compensation due to shares granted to employees .....	134,100	--
Adjustment of stock based compensation related to non-recourse note granted to stockholder .....	(11,500)	4,500
Write-off of inventory .....	--	41,487
Earnings to minority .....	32,954	546
Interest expenses accrued on promissory notes issued to purchase of subsidiary .....	2,442	--
Interest accrued on certificates of deposit due within one year .....	(58,188)	(33,738)
Amortization of premium related to restricted securities .....	38,794	33,993
Capital gain from sale of property and equipment .....	--	(5,744)
Interest accrued on long-term loans .....	--	449
Liability for employee rights upon retirement, net .....	57,666	(383,589)
Decrease (increase) in deferred tax assets .....	72,624	(16,809)
Changes in operating asset and liability items:		
Decrease in trade receivables .....	1,822,948	2,206,100
Decrease (increase) in unbilled receivables .....	(349,083)	544,000
Decrease (increase) in other accounts receivable and prepaid expenses .....	(194,297)	76,912
Increase in inventories .....	(1,447,620)	(1,398,145)
Decrease in trade payables .....	(2,130,990)	(53,819)
Increase (decrease) in deferred revenues .....	75,700	(467,562)
Decrease in accounts payable and accruals .....	(754,834)	(1,184,388)
	-----	-----
Net cash used in operating activities from continuing operations (reconciled from ... continuing operations)	(3,452,006)	(1,416,761)
Net cash used in operating activities from discontinued operations (reconciled from discontinued operations) .....	--	(56,116)
	-----	-----
Net cash used in operating activities .....	(3,452,006)	(1,472,877)

</TABLE>

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

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

<TABLE>

<S>	<C>	<C>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Repayment of promissory note related to purchase of subsidiary .....	(75,000)	(75,000)
Investment in subsidiary(1) .....	--	(7,186,837)
Investment in subsidiary(2) .....	--	(12,106,358)
Purchase of property and equipment .....	(342,248)	(234,032)
Increase in capitalized research and development projects .....	(37,293)	(67,482)
Proceeds from sale of property and equipment .....	--	10,284
Decrease in demo inventories, net .....	--	1,185
Increase in restricted securities and deposits, net .....	(50,141)	(8,418,569)
	-----	-----
Net cash used in investing activities .....	(504,682)	(28,076,809)
	-----	-----
FORWARD .....	\$ (3,956,688)	\$ (29,549,686)

</TABLE>

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

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

<TABLE>

<CAPTION>

	Three months ended March 31,	
	2005	2004
	-----	-----
<S>	<C>	<C>
FORWARD .....	\$ (3,956,688)	\$ (29,549,686)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase (decrease) in short-term credit from banks .....	(99,156)	432,858
Proceeds from issuance of share capital, net .....	--	17,807,500
Proceeds from exercise of options .....	15,000	5,468
Proceeds from exercise of warrants .....	--	2,490,723
Payment on capital lease obligation .....	--	(914)
Repayment of long-term loans .....	(22,226)	(14,228)
	-----	-----
Net cash provided by financing activities .....	(106,382)	20,721,407
	-----	-----
DECREASE IN CASH AND CASH EQUIVALENTS .....	(4,063,070)	(8,828,279)
CASH EROSION DUE TO EXCHANGE RATE DIFFERENCES .....	698	(4,051)
BALANCE OF CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD ....	6,734,512	13,685,125

BALANCE OF CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD .....	\$ 2,672,140	\$ 4,852,795
	=====	=====
SUPPLEMENTARY INFORMATION ON NON-CASH TRANSACTIONS:		
Issuance of shares and warrants against accrued expenses .....	\$ --	\$ 1,377,008
	=====	=====
Investment in subsidiary against promissory note .....	\$ --	\$ 2,577,097
	=====	=====
Exercise of convertible debentures against shares .....	\$ --	\$ 1,150,000
	=====	=====
SUPPLEMENTAL DISCLOSURE OF CASH FLOWS INFORMATION - CASH PAID DURING THE PERIOD FOR:		
Interest .....	\$ 110,178	\$ 94,865
	=====	=====

</TABLE>

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

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

(1) In January 2004, the Company acquired substantially all of the outstanding ordinary shares of Epsilon Electronic Industries, Ltd. ("Epsilon"). 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 .....	\$ (533,750)
(unaudited)	
Property and equipment (unaudited) .....	709,847
Intangible assets and goodwill (unaudited) .....	9,587,837
	-----
	9,763,934
Issuance of promissory note (unaudited) .....	(2,577,097)
	-----
	\$ 7,186,837
	=====

(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 .....	\$ 2,647,822
(unaudited)	
Property and equipment (unaudited) .....	263,669
Intangible assets and goodwill (unaudited) .....	11,201,695
	-----
	14,113,186
Issuance of shares, net (unaudited) .....	(2,006,828)
	-----
	\$ 12,106,358
	=====

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

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AROTECH CORPORATION

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1: BASIS OF PRESENTATION

a. Company:

Arotech 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, Inc. ("IES"), a wholly-owned subsidiary based in Littleton, Colorado; FAAC Corporation, a wholly-owned subsidiary based in Ann Arbor, Michigan, and FAAC's 80%-owned United Kingdom subsidiary FAAC Limited; Electric Fuel Battery Corporation, a wholly-owned subsidiary based in Auburn, Alabama; Electric Fuel Ltd. ("EFL") a wholly-owned subsidiary based in Beit Shemesh, Israel; Epsilon Electronic Industries, Ltd., a wholly-owned subsidiary located in Dimona, Israel; MDT Protective Industries, Ltd. ("MDT"), 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.

b. Basis of presentation:

The accompanying interim consolidated financial statements have been prepared by Arotech Corporation in accordance with generally accepted accounting principles

for interim financial information, with the instructions to Form 10-Q and with Article 10 of Regulation S-X, and include the accounts of Arotech Corporation and its subsidiaries. Certain information and footnote disclosures, normally included in complete financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted. 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 its financial position at March 31, 2005 and its operating results and cash flows for the three-month periods ended March 31, 2005 and 2004.

The results of operations for the three months ended March 31, 2005 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending December 31, 2005.

The balance sheet at December 31, 2004 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. These consolidated financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

c. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" 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.

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The Company adopted the disclosure provisions of Statement of Financial Accounting Standard No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," which amended certain provisions of Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation." The Company continues to apply the provisions of APB No. 25 in accounting for stock-based compensation.

Under Statement of Financial Accounting Standard 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 three month periods ended March 31, 2005 and 2004:

	Three months ended March 31,	
	2005	2004
	(Unaudited)	
Risk free interest .....	--	2.8%
Dividend yields .....	--	0.0%
Volatility .....	--	0.764
Expected life .....	--	5 years

Pro forma information under SFAS No. 123:

	Three months ended March 31,	
	2005	2004
	Unaudited	
	(U.S. Dollars, except per share data)	
Net income (loss) as reported .....	\$ (2,456,500)	\$ (3,680,889)
Add - stock-based compensation expense determined under APB 25 .....	232,739	--
Deduct - stock based compensation expense determined under fair value method for all awards .....	(449,592)	(210,283)
	=====	=====
Pro forma net loss .....	\$ (2,673,353)	\$ (3,891,172)
	=====	=====
Loss per share:		
Basic and diluted, as reported .....	\$ (0.03)	\$ (0.06)
	=====	=====
Pro forma basic and diluted .....	\$ (0.03)	\$ (0.07)
	=====	=====

NOTE 2: 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. Inventory 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 three months ended March 31, 2005 the Company did not write off any inventory. Inventories are composed of the following:

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AROTECH CORPORATION

	March 31, 2005	December 31, 2004
	----- (Unaudited)	-----
Raw materials .....	\$5,348,653	\$4,087,650
Work-in-progress .....	2,446,231	1,877,889
Finished goods .....	1,051,197	1,311,762
	-----	-----
	\$8,846,081	\$7,277,301
	=====	=====

NOTE 3: IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), "Share-Based Payment," which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation." Statement 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends FASB Statement No. 95, "Statement of Cash Flows." Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

Statement 123(R) must be adopted no later than January 1, 2006. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt Statement 123(R) on the first interim period beginning after January 1, 2006.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company is still in the process of evaluating the method it will use.

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R)'s fair value method will have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in Note 2.c. above to the Company's consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature.

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In March 2005, the SEC staff issued Staff Accounting Bulletin No. 107 (SAB 107) to give guidance on implementation of SFAS 123(R), which the Company plans to consider in implementing SFAS 123(R).

NOTE 4: 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'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 used by the Company in the preparation of its annual financial statement. The Company evaluates performance based upon two primary factors, one is the segment's operating income and the other is 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 three months ended March 31, 2005 and 2004:

<TABLE>  
<CAPTION>

	Simulation and Security	Battery and Power Systems	Armor	All Others	Total
<S>	<C>	<C>	<C>	<C>	<C>
Three months ended March 31, 2005					
Revenues from outside customers	\$ 4,115,651	\$ 3,006,138	\$ 3,265,656	\$ --	\$ 10,387,445
Depreciation expenses and amortization (1)	(402,660)	(222,699)	(491,548)	(35,000)	(1,151,907)
Direct expenses (2)	(3,508,124)	(2,756,990)	(3,316,049)	(1,641,897)	(11,223,060)
Segment income (loss)	\$ 204,867	\$ 26,449	\$ (541,941)	\$ (1,676,897)	(1,987,522)
Financial income (after deduction of minority interest)					(468,978)
Loss from continuing operations					\$ (2,456,500)
Segment assets (3)	31,783,459	13,265,919	20,816,358	759,121	66,624,857
Three months ended March 31, 2004					
Revenues from outside customers	\$ 3,212,083	\$ 2,505,621	\$ 1,464,550	\$ --	\$ 7,182,254
Depreciation expenses and amortization(1)	(385,101)	(282,870)	(29,450)	(35,000)	(732,421)
Direct expenses (2)	(3,167,491)	(2,463,960)	(1,328,452)	(927,106)	(7,887,009)
Segment income (loss)	\$ (340,509)	\$ (241,209)	\$ 106,648	\$ (962,106)	(1,437,176)
Financial expenses (after deduction of minority interest)					(1,080,713)
Loss from continuing operations					\$ (2,517,889)
Segment assets(3)	18,795,589	12,629,305	3,360,366	439,646	35,224,906

</TABLE>

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

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NOTE 5: CONVERTIBLE DEBENTURES AND DETACHABLE WARRANTS

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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company, 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.

As part of the Securities Purchase Agreement dated September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 1,250,000 shares of common stock at any time prior to September 30, 2006 at a price of \$1.4375 per share.

As of March 31, 2005, \$150,000 remained outstanding under these debentures.

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 three years.

In connection with these convertible debentures, the Company recognized financial expenses of \$2,963,043 with respect to the beneficial conversion feature, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - as financial expenses.

During the three months ended March 31, 2005 the Company recorded an expense of \$7,299, which was attributable to amortization of debt discount and beneficial conversion features related to the convertible debenture over its term. These expenses were included in the financial expenses.

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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company, 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.

As of March 31, 2005, \$4,387,500 remained outstanding under these debentures.

As a further part of the Securities Purchase Agreement dated September 30, 2003, 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.

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

In connection with these convertible debentures, the Company recognized financial expenses of \$6,000,000 with respect to the beneficial conversion feature, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - as financial expenses.

During the three months ended March 31, 2005 the Company recorded an expense of \$385,244, which was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term. These expenses were included in the financial expenses.

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#### 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.

We make available through our internet website free of charge our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to such reports and other filings made by us with the SEC, as soon as practicable after we electronically file such reports and filings with the SEC. Our website address is [www.arotech.com](http://www.arotech.com). The information contained in this website is not incorporated by reference in this report.

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, unless otherwise noted) are as follows:

>> Our Simulation and Security Division, consisting of:

- o 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

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- o IES Interactive Training, Inc., located in Littleton, Colorado, which provides specialized "use of force" training for police, security personnel and the military ("IES").
- >> Our Armor Division, consisting of:
- o Armour of America, located in Los Angeles, California, which manufactures ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles and architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique vest that is certified by the U.S. Coast Guard ("AoA");
  - o 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 SUVs, and is a leading supplier to the Israeli military, Israeli special forces and special services ("MDT") (75.5% owned); and
  - o MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT's United States activities ("MDT Armor") (88% owned).
- >> Our Battery and Power Systems Division, consisting of:
- o Epsilon Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area), which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia ("Epsilon");
  - o Electric Fuel Battery Corporation, located in Auburn, Alabama, which manufactures and sells Zinc-Air fuel cells, batteries and chargers for the military, focusing on applications that demand high energy and light weight ("EFB"); and
  - o 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").

Overview of Results of Operations

We incurred significant operating losses for the years ended December 31, 2003 and 2004 and for the first three months of 2005. 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.

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Between 2002 and 2004, we substantially increased our revenues and reduced our net loss, from \$18.5 million in 2002 to \$9.2 million in 2003 to \$9.0 million in 2004. 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 products manufactured by the subsidiaries we acquired in 2002 and 2004.

We succeeded during 2004 in moving Arotech to a positive EBITDA situation, for the first time in our history. We are focused on continuing this success in 2005 (although we had negative EBITDA during the first three months of 2005) and beyond, and ultimately on achieving profitability. 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 2005 as well.

A portion of our operating loss during the first three months of 2005 arose as a result of non-cash charges. These charges were primarily related to our acquisitions made in the previous year and to our raising capital through convertible debenture in the prior years. 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, Epsilon and AoA resulted in our incurring similar non-cash charges during the first three months of 2005.

As a result of the application of the above accounting rule, we incurred non-cash charges related to our acquisitions in the amount of \$823,000 during the first three months of 2005.

The non-cash charges that relate to our financings arise when we sell convertible debentures and 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 convertible debentures; when the convertible debentures are converted, the entire remaining unamortized financial expense is immediately recognized in the quarter in which the conversion occurs. As and to the extent that our remaining convertible debentures are converted, we would incur similar non-cash charges going forward.

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As a result of the application of the above accounting rule, we incurred non-cash charges related to our financings in the amount of \$393,000 during the first three months of 2005.

Additionally, in an effort to improve our cash situation and our shareholders' equity, we have periodically induced holders of certain of our warrants to exercise their warrants by lowering the exercise price of the warrants in exchange for immediate exercise of such warrants, and by issuing to such investors new warrants. Under such circumstances, we record a deemed dividend in an amount determined based upon the fair value of the new warrants (using 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 recorded a deemed dividend related to warrants repricing in amount of \$0 and \$1.2 million during the first three months of 2005 and 2004 respectively.

In addition, we incurred non-cash charges in the amount of \$221,000 during the first three months of 2005 in connection with options and shares granted to employees.

#### 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 our Simulation and Security Division, revenues grew from approximately \$3.2 million in the first three months of 2004 to \$4.1 million in the first three months of 2005. As of March 31, 2005, our backlog for our Simulation and Security Division totaled \$10.6 million, most of which was attributable to FAAC.

In our Battery and Power Systems Division, revenues grew from approximately \$2.5 million in the first three months of 2004 to approximately \$3.0 million in the first three months of 2005. As of March 31, 2005, our backlog for our Battery and Power Systems Division totaled \$2.8 million.

In our Armor Division, revenues grew from \$1.5 million during the first three months of 2004 to \$3.3 million during the first three months of 2005, due primarily to increased revenues of MDT Armor as a result of new orders in connection with the war in Iraq and the inclusion of AoA in our results. As of March 31, 2005, our backlog for our Armor Division totaled \$8.3 million.

#### 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.

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The majority of financial transactions of our Israeli subsidiaries MDT and Epsilon, is in New Israel Shekels ("NIS") and a substantial portion of MDT's and Epsilon's costs is incurred in NIS. Management believes that the NIS is the

functional currency of MDT and Epsilon. Accordingly, the financial statements of MDT and Epsilon have been translated into U.S. dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of accumulated other comprehensive loss in shareholders' equity.

#### Results of Operations

##### Preliminary Note

Results for the three months ended March 31, 2005 include the results of AoA for such period as a result of our acquisition of AoA in August 2004. The results of AoA were not included in our operating results for the three months ended March 31, 2004. Accordingly, the following period-to-period comparisons should not necessarily be relied upon as indications of future performance.

Three months ended March 31, 2005 compared to the three months ended March 31, 2004.

Revenues. During the three months ended March 31, 2005, we (through our subsidiaries) recognized revenues as follows:

- >> IES and FAAC recognized revenues from the sale of interactive use-of-force training systems and from the provision of maintenance services in connection with such systems;
- >> MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products;
- >> EFB and Epsilon recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army; 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 March 31, 2005 totaled \$10.4 million, compared to \$7.2 million in the comparable period in 2004, an increase of \$3.2 million, or 45%. This increase was primarily attributable to the following factors:

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- >> Increased revenues from our Armor Division, particularly MDT Armor and revenues generated by AoA (\$726,000) in the first quarter of 2005 that were not present in the corresponding period of 2004.
- >> Increased revenues from our Simulation and Security division, particularly FAAC.

These revenues were offset to some extent by

>> Decreased U.S. Army Communications Electronics Command (CECOM) revenues from our EFB subsidiary.

In the first quarter of 2005, revenues were \$4.1 million for the Simulation and Security Division (compared to \$3.2 million in the first quarter of 2004, an increase of \$904,000, or 28.1%, due primarily to increased sales of FAAC); \$3.0 million for the Battery and Power Systems Division (compared to \$2.5 million in the first quarter of 2004, an increase of \$501,000, or 20.0%, due primarily to increased sales of Epsilon, offset to some extent by decreased CECOM revenues from our EFB subsidiary); and \$3.3 million for the Armor Division (compared to \$1.5 million in the first quarter of 2004, an increase of \$1.8 million, or 123.0%, due primarily to increased revenues from MDT Armor and to the added revenues of AoA).

Cost of revenues and gross profit. Cost of revenues totaled \$6.4 million during the first quarter of 2005, compared to \$4.6 million in the first quarter of 2004, an increase of \$1.8 million, or 39.8%, due primarily to increased sales in all divisions.

Direct expenses for our three divisions during the first quarter of 2005 were \$3.5 million for the Simulation and Security Division (compared to \$3.2 million in the first quarter of 2004, an increase of \$341,000, or 10.8%, due primarily to increased sales of FAAC); \$2.8 million for the Battery and Power Systems Division (compared to \$2.5 million in the first quarter of 2004, an increase of \$293,000, or 11.9%, due primarily to increased sales of Epsilon, offset to some extent by decreased CECOM revenues from our EFB subsidiary; and \$3.3 million for the Armor Division (compared to \$1.3 million in the first quarter of 2004, an increase of \$2.0 million, or 149.6%, due primarily to increased revenues from MDT Armor and to the added revenues of AoA).

Gross profit was \$4.0 million during the first quarter of 2005, compared to \$2.6 million during the first quarter of 2004, an increase of \$1.4 million, or 53.0%. This increase was the direct result of all factors presented above, most notably the presence of AoA in our results and the increase in vehicle armoring revenues.

Research and development expenses. Research and development expenses for the first quarter of 2005 were \$415,000, compared to \$464,000 during the first quarter of 2004, a decrease of \$49,000, or 10.5%.

Sales and marketing expenses. Sales and marketing expenses for the first quarter of 2005 were \$1.2 million, compared to \$1.0 million the first quarter of 2004, an increase of \$138,000, or 13.5%. This increase was primarily attributable to the inclusion of the sales and marketing expenses of AoA in our results for 2004.

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General and administrative expenses. General and administrative expenses for the first quarter of 2005 were \$3.4 million compared to \$2.1 million in the first quarter of 2004, an increase of \$1.3 million, or 60.7%. This increase was primarily attributable to the following factors:

- >> The inclusion of the general and administrative expenses of AoA in our results for 2004; and
- >> Increases in other general and administrative expenses in comparison to 2004, such as employees salaries, travel expenses and audit fees.
- >> Increase in expenses in connection with grant of options and shares to employees.

Financial expenses, net. Financial income, net of financial expenses and exchange differentials, totaled approximately \$469,000 in the first quarter of 2005 compared to \$1.1 million in the first quarter of 2004. The difference was due primarily to decrease in amortization of debt discount related to the issuance of convertible debenture.

Income taxes. We and certain of our subsidiaries incurred accumulated net operating losses during the three months ended March 31, 2005 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 2005, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of \$217,000 in tax expenses in the first quarter of 2005, with respect to certain of our subsidiaries that operated at a net profit during 2005 and we are not able to offset their taxes against our loss carry forward. We recorded a total of \$5,000 in tax income in the first quarter of 2004, on account of deferred tax assets with respect to certain of our subsidiaries.

Amortization of intangible assets. Amortization of intangible assets totaled \$823,000 in the first quarter of 2005, compared to \$496,000 the first quarter of 2004, an increase of \$327,000, or 65.9%, due primarily to amortization of intangible assets related to our subsidiary, AoA, that we acquired in August 2004.

Net loss before deemed dividend to certain stockholders of common stock. Due to the factors cited above, we reported a net loss of \$2.5 million in the first quarter of 2005, compared to a net loss of \$2.5 million the first quarter of 2004, a decrease of \$61,000, or 2.4%.

Net loss attributable to common stockholders. Due to the factors cited above and the deemed dividend recorded during the first three months of 2004, Net loss attributable to common stockholders decreased from \$3.7 million to \$2.5 million, a decrease of \$1.2 million, or 33.3%.

#### Liquidity and Capital Resources

As of March 31, 2005, we had \$2.7 million in cash, \$7.0 million in restricted collateral securities and cash deposits due within one year, \$4.0 million in long-term restricted securities and deposits, and \$135,000 in marketable securities, as compared to at December 31, 2004, when we had \$6.7 million in cash, \$7.0 million in restricted collateral securities and restricted held-to-maturity securities due within one year, \$4.0 million in long-term restricted deposits, and \$136,000 in available-for-sale marketable securities. The decrease in cash was primarily the result of working capital needed in all of our segments.

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We used available funds in the first quarter of 2005 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets during the three months ended March 31, 2005 by \$342,000 over the investment as at December 31, 2004, primarily in the Battery and Power Systems Division and in the Simulation and Security Division. Our net fixed assets amounted to \$4.5 million at quarter end.

Net cash used in operating activities from continuing operations for the three months ended March 31, 2005 and 2004 was \$3.5 million and \$1.4 million, respectively, an increase of \$2.0 million. This increase was primarily the result of increase in inventories and decrease in trade payables and other account payables.

Net cash used in investing activities for the three months ended March 31,

2005 and 2004 was \$505,000 and \$28.1 million, a decrease of \$27.6 million. This decrease was primarily the result of our investment in the acquisition of FAAC and Epsilon in the first quarter of 2004.

Net cash provided by (used in) financing activities for the three months ended March 31, 2005 and 2004 was \$(106,000) and \$20.7 million, respectively. This decrease was primarily the result of lower amounts of funds raised through sales of our securities in 2005 compared to 2004.

As of March 31, 2005, we had (based on the contractual amount of the debt and not on the accounting valuation of the debt) approximately \$5.5 million in long term bank and certificated debt outstanding, of which \$4.5 million was convertible debt, and approximately \$13.6 million in short-term debt (which including short-term bank credit, current portion of long-term loan and liabilities due to subsidiaries acquisitions, in the amount of \$13.5 million).

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, and contain certain other affirmative and negative covenants. We do not believe that these covenants 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 twelve months. This belief is based on certain assumptions that our management and our subsidiaries managers believes to be reasonable, some of which are subject to the risk factors detailed below. In this connection, we note that from time to time our working capital needs are partially dependent on our subsidiaries' lines of credit. In the event that we are unable to continue to make use of our subsidiaries' lines of credit for working capital on economically feasible terms, our business, operating results and financial condition could be adversely affected.

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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 or exercisable 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 net losses since our inception. Additionally, as of March 31, 2005, we had an accumulated deficit of approximately \$121.4 million. There can be no assurance that we will ever be able to achieve or 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 (short and long term) aggregated approximately \$19.1 million as of March 31, 2005 (not including trade payables, other account payables and accrued severance pay). Accordingly, we are subject to the risks associated with indebtedness, including:

- o 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;
- o it may be more difficult and expensive to obtain additional funds through financings, if available at all;
- o 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
- o 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.

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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 future cash flow or assets would be sufficient to repay in full such indebtedness.

Failure to comply with the earnout provisions of our acquisition agreements could have material adverse consequences for us.

A failure to comply with the obligations contained in our acquisition agreements to make the earnout payments required under such agreements could result in actions for damages, a possible right of rescission on the part of the sellers, and the acceleration of debt under instruments evidencing indebtedness that may contain cross-acceleration or cross-default provisions. If we are unable to raise capital in order to pay the earnout provisions of our acquisition agreements, there can be no assurance that our future cash flow or assets would be sufficient to pay such obligations.

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, on acceptable terms, or at all. 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.

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Any inability to continue to make use from time to time of our subsidiaries' current working capital lines of credit could have an adverse effect on our ability to do business.

From time to time our working capital needs are partially dependent on our subsidiaries' lines of credit. In the event that we are unable to continue to make use of our subsidiaries' lines of credit for working capital on economically feasible terms, our business, operating results and financial condition could be adversely affected.

We may not be successful in operating new businesses.

Prior to the acquisitions of IES and MDT in 2002 and the acquisitions of FAAC and Epsilon 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 relatively 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 these new businesses. 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 officers, 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.

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We may not successfully integrate our acquisitions.

In light of our acquisitions of IES, MDT, FAAC, Epsilon 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 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.

As a result of our acquisitions, we are currently experiencing a period of significant 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 and reduction or reallocation of defense or law enforcement spending could reduce our revenues.

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 or law enforcement spending in the U.S. or other countries could reduce our revenues and 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.

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 reduce our revenues and have a material adverse effect on our future results of operations and financial condition.

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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:

- o the U.S. Federal Acquisition Regulations, which regulate the formation, administration and performance of government contracts;

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- o the U.S. Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations; and
- o 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. 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.

The loss of, or a significant reduction in, U.S. military business would have a material adverse effect on us.

U.S. military contracts account for a significant portion of our business. The U.S. military funds these contracts in annual increments. These contracts require subsequent authorization and appropriation that may not occur or that may be greater than or less than the total amount of the contract. Changes in the U.S. military's budget, spending allocations and the timing of such spending could adversely affect our ability to receive future contracts. None of our contracts with the U.S. military has a minimum purchase commitment, and the U.S. military generally has the right to cancel its contracts unilaterally without prior notice. We manufacture for the U.S. aircraft and land vehicle armor systems, protective equipment for military personnel and other technologies used to protect soldiers in a variety of life-threatening or catastrophic situations, and batteries for communications devices. The loss of, or a significant reduction in, U.S. military business for our aircraft and land vehicle armor systems, other protective equipment, or batteries could have a material adverse effect on our business, financial condition, results of operations and liquidity.

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A reduction of U.S. force levels in Iraq may affect our results of operations.

Since the invasion of Iraq by the U.S. and other forces in March 2003, we have received steadily increasing orders from the U.S. military for armoring of vehicles and military batteries. These orders are the result, in substantial part, from the particular combat situations encountered by the U.S. military in Iraq. We cannot be certain, therefore, to what degree the U.S. military would continue placing orders for our products if the U.S. military were to reduce its force levels or withdraw completely from Iraq. A significant reduction in orders from the U.S. military could have a material adverse effect on our business, financial condition, results of operations and liquidity.

There are limited sources for some of our raw materials, which may significantly curtail our manufacturing operations.

The raw materials that we use in manufacturing our armor products include Kevlar(R), a patented product of E.I. du Pont de Nemours Co., Inc. We purchase Kevlar in the form of woven cloth from various independent weaving companies. In the event Du Pont and/or these independent weaving companies were to cease, for any reason, to produce or sell Kevlar to us, we might be unable to replace it with a material of like weight and strength, or at all. Thus, if our supply of Kevlar were materially reduced or cut off or if there were a material increase in the price of Kevlar, our manufacturing operations could be adversely affected and our costs increased, and our business, financial condition and results of operations could be materially adversely affected.

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, 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. In the event that our products, including the products manufactured by MDT and AoA, 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.

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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.

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.

Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours. 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.

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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. 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 Epsilon 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 2007. 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 2004, 2003 and 2002, without taking account of revenues derived from discontinued operations, 19%, 42% and 56%, 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.

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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:

- o Announcements by us, our competitors or our customers;
- o The introduction of new or enhanced products and services by us or our competitors;
- o Changes in the perceived ability to commercialize our technology compared to that of our competitors;
- o Rumors relating to our competitors or us;
- o Actual or anticipated fluctuations in our operating results;
- o The issuance of our securities, including warrants, in connection with financings and acquisitions; and
- o 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 traded below \$1.00 in the 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.

Our management has determined that we have material weaknesses in our internal controls. If we fail to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act, we may not be able to accurately report our financial results.

We have, with our auditors' concurrence, identified significant deficiencies that constitute material weaknesses under standards established by the Public Company Accounting Oversight Board (PCAOB). A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our auditors have reported to us that at December 31, 2004, we had material weaknesses for inadequate controls related to the financial statement close process, convertible debentures and share capital processes as it applies to non-routine and highly complex financial transactions. The material weaknesses arise from insufficient staff with technical accounting expertise to independently apply our accounting policies, as they relate to non-routine and highly complex transactions, in accordance with U.S. generally

accepted accounting principles.

As a public company, we will have significant requirements for enhanced financial reporting and internal controls. The process of designing and implementing effective internal controls is a continuous effort that requires us to anticipate and react to changes in our business and the economic and regulatory environments and to expend significant resources to maintain a system of internal controls that is adequate to satisfy our reporting obligations as a public company. We cannot assure you that the measures we have taken or will take to remediate any material weaknesses or that we will implement and maintain adequate controls over our financial processes and reporting in the future as we continue our rapid growth. If we are unable to establish appropriate internal financial reporting controls and procedures, it could cause us to fail to meet our reporting obligations, result in material misstatements in our financial statements, harm our operating results, cause investors to lose confidence in our reported financial information and have a negative effect on the market price for shares of our common stock.

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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 March 31, 2005, we had 80,103,668 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.

Exercise of our warrants, options and convertible debt could adversely affect our stock price and will be dilutive.

As of March 31, 2005, there were outstanding warrants to purchase a total of 16,961,463 shares of our common stock at a weighted average exercise price of \$1.55 per share, options to purchase a total of 9,284,047 shares of our common stock at a weighted average exercise price of \$1.33 per share, of which 7,168,676 were vested, at a weighted average exercise price of \$1.34 per share, and outstanding debentures convertible into a total of 3,156,298 shares of our common stock at a weighted average conversion price of \$1.44 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:

- o divide our board of directors into three classes serving staggered three-year terms;
- o 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
- o allow us to issue preferred stock without any vote or further action by the stockholders.

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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

Epsilon, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of our senior management is located at EFL's facilities. 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 22% of our assets are located outside the United States. In addition, two of our directors and most 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.

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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 2004, 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 Epsilon. 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 2005. Certain of our research, development and production activities are 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 Epsilon 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

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ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

As of March 31, 2005, our management, including the principal executive officer and principal financial officer, evaluated our disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in our periodic reports that we file with the SEC. These disclosure controls and procedures are intended to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers, by other of our employees, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Any system of controls and procedures, no matter how well designed and operated, can at best provide only reasonable assurance that the objective of the system are met and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met.

Based on their evaluation, our principal executive officer and principal financial officer concluded that our controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were not effective as of March 31, 2005.

Our management has not completed implementation of the changes it believes are required to remediate the previously reported material weaknesses for inadequate controls related to the financial statement close process, convertible debentures and share capital processes as it applies to non-routine and highly complex financial transactions. The material weaknesses arise from insufficient staff with technical accounting expertise to independently apply our accounting policies, as they relate to non-routine and highly complex transactions, in accordance with U.S. generally accepted accounting principles. Management has identified that due to the reasons described above, we did not consistently follow established internal control over financial reporting procedures related to the analysis, documentation and review of selection of the appropriate accounting treatment for non-routine and highly complex transactions. Because of these material weaknesses, we have concluded that we did not maintain effective internal control over financial reporting as of March 31, 2005, based on the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in Internal Control - Integrated Framework.

In light of the material weakness described above, our management performed additional analyses and other post-closing procedures to ensure our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP). Accordingly, management believes that the consolidated financial statements included in this report fairly present in all material respects our financial position, results of operations and cash flows for the periods presented.

AROTECH CORPORATION

Management's Response to the Material Weaknesses

In response to the material weaknesses described above, we have undertaken to take the following initiatives with respect to our internal controls and procedures that we believe are reasonably likely to improve and materially affect our internal control over financial reporting. We anticipate that remediation will be continuing throughout fiscal 2005, during which we expect to continue pursuing appropriate corrective actions, including the following:

- >> Preparing appropriate written documentation of our financial control procedures;
- >> Adding additional qualified staff to our finance department;
- >> Scheduling training for accounting staff to heighten awareness of generally accepted accounting principles applicable to complex transactions;
- >> Strengthening our internal review procedures in conjunction with our ongoing work to enhance our internal controls so as to enable us to identify and adjust items proactively;
- >> Engaging an outside accounting firm to support our Sarbanes-Oxley Section 404 compliance activities and to provide technical expertise in the selection and application of generally accepted accounting



principles related to complex transactions to identify areas that require control or process improvements and to consult with us on the appropriate accounting treatment applicable to complex transactions; and

>> Implementing the recommendations of our outside accounting consultants.

Our management and Audit Committee will monitor closely the implementation of our remediation plan. The effectiveness of the steps we intend to implement is subject to continued management review, as well as Audit Committee oversight, and we may make additional changes to our internal control over financial reporting.

#### Changes in Internal Controls Over Financial Reporting

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

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### AROTECH CORPORATION

#### PART II

#### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

##### Issuance of Restricted Stock to Certain Employees

In January 2005, we granted 10,000 shares of our common stock as a stock bonus to an employee. Under the terms of this grant, the sale or other transfer of these shares is restricted for a period of two years from the date of grant, and such shares automatically return to us if the employee leaves our employ during such two-year period under circumstances that would not entitle the employee to statutory severance under Israeli law (generally, resignation without good cause or dismissal with good cause).

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 were issued with restrictive legends permitting transfer thereof only upon registration or an exemption under the Act.

#### ITEM 6. EXHIBITS.

The following documents are filed as exhibits to this report:

Exhibit Number	Description
*10.1	Agreement signed on May 15, 2005 among Electric Fuel (E.F.L.) Ltd., Arotech Corporation and Robert S. Ehrlich
*10.2	Agreement signed on May 15, 2005 between Electric Fuel (E.F.L.) Ltd. and Steven Esses
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

\* Includes management contracts and compensation plans and arrangements.

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#### SIGNATURES

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: May 16, 2005

AROTECH CORPORATION

By: /s/ Robert S. Ehrlich

Name: Robert S. Ehrlich  
Title: Chairman, President and CEO

(Principal Executive Officer)

By: /s/ Avihai Shen

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

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AROTECH CORPORATION

EXHIBIT INDEX

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-----  
\* Includes management contracts and compensation plans and arrangements.

THIRD AMENDED AND RESTATED EMPLOYMENT AGREEMENT

THIS AGREEMENT ("Agreement") is signed on May 15, 2005, effective as of the 1st day of January, 2005 and is entered into by and among Arotech Corporation, a Delaware corporation ("Arotech"), and Electric Fuel (E.F.L.) Limited, an Israeli company ("EFL" and together with Arotech, the "Companies"), and Mr. Robert S. Ehrlich, Israel I.D. Number 303673487 (the "Executive").

WHEREAS, the Companies and the Executive entered into an Amended and Restated Employment Agreement dated as of October 1, 1996 and a Second Amended and Restated Employment Agreement dated as of January 1, 2000, as extended (together, the "Original Agreement") formalizing the terms of the Executive's employment with the Companies;

WHEREAS, the Executive is within one year of the minimum age set forth in his existing employment agreement for retirement;

WHEREAS, the Companies and the Executive now wish to extend the Executive's employment and to amend and restate the Original Agreement in its entirety in accordance with the terms of this Agreement;

NOW, THEREFORE, in consideration of the respective agreements of the parties contained herein, the parties agree as follows:

1. Term.

The term of the Executive's employment under this Agreement shall be for the period commencing on January 1, 2005, and ending on December 31, 2007 (the "Initial Term"), provided, however, that the term of this Agreement shall be automatically extended for additional terms of one (1) year each (each, an "Additional Term") upon the end of the Initial Term and each Additional Term, unless either the Executive or both Companies shall have given written notice to the other at least one hundred twenty days (120) days prior thereto that the term of this Agreement shall not be so extended (a "Non-Renewal"). The provisions of this Agreement shall apply to the relationship between the parties hereto retroactively as if this Agreement were signed on the commencement of the Initial Term.

2. Employment.

- (a) The Executive shall be employed as the Chairman of the Board, President and Chief Executive Officer of Arotech. The Executive shall perform the duties, undertake the responsibilities and exercise the authority customarily performed, undertaken and exercised by persons situated in a similar executive capacity in publicly-held United States corporations and their Israeli subsidiaries. The Executive shall exercise his authority in a reasonable manner and shall report to the Board of Directors of each Company (each a "Board").
- (b) Excluding periods of vacation and sick leave to which the Executive shall be entitled, the Executive agrees to devote the attention and time to the businesses and affairs of the Companies required to discharge the responsibilities assigned to the Executive hereunder. The Executive's duties shall be in the nature of management duties that demand a special level of loyalty and accordingly the Israeli Law of Work Hours and Rest, 5711 - 1951 shall not apply to this Agreement.

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- (c) While the Executive is employed by the Companies hereunder, Arotech shall use its best efforts to cause the Executive to be elected to, and if so elected the Executive shall serve on, the Board of Arotech as a member of such Board, and shall cause the Executive to be elected to, and the Executive shall serve on, the Board of EFL as a member of such Board.
- (d) Each Company will use its reasonable best efforts to obtain, and to keep in place at all times that the Executive is a director or officer of either Company, a directors and officers liability policy covering the Executive in an amount and otherwise containing terms and conditions consistent with past practices.

(e) The Executive agrees to serve on the board of directors of such subsidiaries of the Companies as the Board may reasonably request.

3. Base Salary, Bonus and Financial Planning Allowance.

(a) The Companies agree to pay or cause to be paid to the Executive a base salary at the rate of US \$23,750 per month during the first year of this Agreement, US \$25,000 per month during the second year of this Agreement, and US \$26,500 per month during the third year of this Agreement, payable in U.S. Dollars or in the currency of Israel (as determined by the Representative Rate of the U.S. Dollar published by the Bank of Israel immediately prior to the date of payment of each installment thereof), or such larger amount as the Board may in its sole discretion determine following a review which shall be conducted by the Board by not later than March 31 of each year, such larger amount to take effect retroactively to the January 1 immediately preceding such review (hereinafter referred to as the "Base Salary"). Notwithstanding such review, on each anniversary of the effective date of this Agreement, the Base Salary shall be adjusted upward in an amount equal to the official anticipated net Israeli inflation rate as published by the Israeli Central Bureau of Statistics in the month of December immediately preceding such anniversary, in each case for the year immediately following such anniversary, as adjusted for any changes in the value of the New Israeli Shekel against the U.S. Dollar. Such Base Salary shall be payable in equal monthly installments.

(b) The Companies agree to pay or cause to be paid to the Executive on each anniversary of this Agreement or as soon thereafter as may be possible in order to determine the relevant results of the Companies, an annual bonus, in an amount of not less than 35% of the Executive's annual Base Salary as then in effect for the year preceding such anniversary, as follows:

(i) If, as of such anniversary, the Companies shall have attained 120% of the Companies' Budgeted Number (as defined below) for the year preceding such anniversary, then Executive's bonus shall be equal to 90% of Executive's annual Base Salary as then in effect for the year preceding such anniversary;

(ii) If, as of such anniversary, the Companies shall have attained more than 80% but less than 120% of the Companies' Budgeted Number (as defined below), then Executive's bonus shall be calculated as follows:

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$$B = (S \times 35\%) + (N-80)/40 \times (S \times 55\%)$$

Where:

B = The amount of Executive's annual bonus, as a percentage of Executive's Base Salary; and

N = The percentage of the Budgeted Number (as defined below) that was attained by the Companies in the immediately preceding fiscal year; provided, however, that N is more than 80 and less than 120;

S = Executive's Base Salary.

For the purposes of this Section 3(b), the Budgeted Number shall be the budgeted results of the Companies as mutually agreed by the Boards and Executive prior to the end of each fiscal year for the fiscal year designated in such budget.

(c) In addition, the Companies shall pay Executive an amount of \$10,000 on each anniversary of this Agreement to cover Executive's tax and financial planning expenses. The Companies acknowledge that the Executive is owed an amount of \$30,000 in connection with tax and financial planning expenses from previous years.

(d) To the maximum extent permitted by law, all payments to the Executive hereunder shall be paid in U.S. Dollars. Subject to the immediately preceding sentence, and subject to the approval of the Executive, which shall not be unreasonably withheld, the Companies, in order to reflect the

different duties of the Executive with respect to each of them, may allocate between themselves their obligations to make the payments and provide the benefits specified in this Agreement. The amount paid to the Executive hereunder by EFL shall be referred to hereinafter as the "EFL Base Salary"; provided, that in no event shall the EFL Base Salary in any year be greater than the Base Salary for that year.

4. Employee Benefits.

The Executive shall be entitled to the following benefits:

(a) Manager's Insurance. The Companies will pay to an insurance company of the Executive's choice, as premiums for manager's insurance for the Executive, an amount equal to 13.33% of each monthly payment of the Base Salary together with 2.5% of the Base Salary for disability, and will deduct from each monthly payment of the Base Salary and pay to such insurance company an amount equal to 5% of each monthly payment of the Base Salary, which shall constitute the Executive's contribution to such premiums. Upon the termination of the Executive's employment with the Companies for whatever reason, including without limitation termination for Cause or the resignation by the Executive, the right to receive the manager's insurance benefits shall be automatically assigned to the Executive.

(b) Education Fund (Keren Hishtalmut). The Companies will contribute to an education fund of the Executive's choice an amount equal to 7.5% of each monthly payment of the Base Salary, and will deduct from each monthly payment of the Base Salary and contribute to such education fund an additional amount equal to 2.5% of each such monthly payment of the Base Salary. Upon the termination of the Executive's employment with the Companies for whatever reason, including without limitation termination for Cause or the resignation by the Executive, the right to receive any amounts in such fund shall be automatically assigned to the Executive. All education fund contributions or imputed income made under this Section in excess of the statutory exemption shall be tax-effected such that the amount of contribution net of any taxes and withholding (including such amounts in respect of payments pursuant to this sentence) equals the percentages specified herein.

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(c) Vacation. The Executive shall be entitled to an annual vacation at full pay equal to 24 work days.

Vacation days may be accumulated and may, at the Executive's option or automatically upon termination, be converted into cash payments in an amount equal to the proportionate part of the Base Salary for such days; provided, however, that if the Executive accumulates more than two (2) times his then current annual entitlement of vacation days, such excess shall be automatically converted into the right to receive such a cash payment in respect of such excess. Payments to which the Executive is entitled pursuant to this Section 4(c) shall be made promptly after the Executive's request therefor.

(d) Sick Leave. The Executive shall be entitled to 30 days of fully paid sick leave; provided, however, that the Executive shall not be entitled to sick leave payment to the extent he is already covered by manager's insurance. Sick leave may be accumulated and may, at the Executive's option, be converted into cash payments in an amount equal to the proportionate part of the Base Salary for such days. Payments to which the Executive is entitled pursuant to this Section 4(d) shall be made promptly after the Executive's request therefor.

(e) Automobile. Every three years, the Companies shall make a new automobile available to the Executive during the term of this Agreement. Such automobile shall be of a high quality comparable to, but not less than, that of a current (2004, with respect to the Initial Term) model Volvo S-80, to other cars and shall be subject to the approval of the Executive, which shall not be unreasonably withheld. The Executive shall be entitled to use the automobile for his personal and business needs, so long as he does not allow anyone who would not be covered by the Companies' insurance to drive it. The Companies shall pay all expenses of maintaining and operating the automobile. All expense reimbursements or imputed income

made under this Section shall be tax-effected such that the amount of reimbursement received by the Executive net of any taxes and withholdings (including such amounts in respect of payments pursuant to this sentence) equals the expense incurred.

- (f) Recuperation Payments (D'mai Havra-ah). The Executive shall be entitled to Recuperation Payments in accordance with the Companies' policies for all of its management employees, but no less than required by law.
- (g) Benefit Plans. The Executive shall be entitled to participate in all incentive, bonus, benefit or other similar plans offered by either of the Companies, including without limitation Arotech's 2004 Stock Option and Restricted Stock Purchase Plan, in accordance with the terms thereof and as determined by the Boards from time to time.

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#### 5. Expenses.

The Executive shall be entitled to receive prompt reimbursement of all expenses reasonably incurred by him in connection with the performance of his duties hereunder. Without limiting the generality of the foregoing, the Companies shall pay all of the Executive's expenses in the use of telephones for the Companies' businesses. The Executive shall be entitled to receive room, board and travel reimbursement in connection with the performance of his duties other than at the principal executive office of either Company, as is customary for senior executives in publicly-held United States and Israeli companies. All expense reimbursements made under this Section shall be tax-effected such that the amount of reimbursement received by the Executive net of any taxes and withholdings (including such amounts in respect of payments pursuant to this sentence) equals the expense incurred.

#### 6. Termination.

The Executive's employment hereunder shall and/or may be terminated under the following circumstances:

- (a) Death. This Agreement shall terminate upon the death of the Executive.
- (b) Disability. The Companies may terminate the Executive's employment after having established the Executive's Disability. For purposes of this Agreement, "Disability" means a physical or mental infirmity which impairs the Executive's ability to substantially perform his duties under this Agreement which continues for a period of at least one hundred and eighty (180) consecutive days.
- (c) Cause. The Companies may terminate the Executive's employment for Cause. For purposes of this Agreement, ----- termination for "Cause" shall mean and include: (i) conviction for fraud, crimes of moral turpitude or other conduct which reflects on the Companies in a material and adverse manner; (ii) a willful failure to carry out a material directive of either of the Boards, provided that such directive concerned matters within the scope of the Executive's duties, was in conformity with Sections 2(a) and 2(b) hereof, would not give the Executive Good Reason to terminate this Agreement and was capable of being reasonably and lawfully performed; (iii) conviction in a court of competent jurisdiction for embezzlement of funds of the Companies; and (iv) reckless or willful misconduct that is materially harmful to either of the Companies; provided, however, that the Companies may not terminate the Executive for Cause unless they have given the Executive (i) written notice of the basis for the proposed termination given not more than thirty (30) days after the Companies have obtained knowledge of such basis ("Companies' Notice of Termination") and (ii) a period of at least thirty (30) days after the Executive's receipt of such notice in which to cure such basis.
- (d) Good Reason. The Executive may terminate his employment under this Agreement for Good Reason. For purposes of this Agreement, "Good Reason" shall mean the occurrence of any of the events or conditions described in subsections (i) through (viii) hereof:

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- (i) a change in the Executive's status, title, position or responsibilities which, in the Executive's reasonable judgment, represents a reduction or demotion in the Executive's status, title, position or responsibilities as in effect immediately prior thereto;
- (ii) a reduction in the Executive's Base Salary;
- (iii) the failure by the Companies to continue in effect any material compensation or benefit plan in which the Executive is participating;
- (iv) the insolvency or the filing (by any party, including the Companies) of a petition for the winding-up of either of the Companies;
- (v) any material breach by the Companies of any provision of this Agreement;
- (vi) any purported termination of the Executive's employment for Cause by the Companies which does not comply with the terms of Section 6(c) of this Agreement;
- (vii) any movement of either Company's principal executive offices from the Jerusalem/Tel Aviv area of Israel; and
- (viii) any movement of the location where the Executive is generally to render his services to the Companies hereunder from the Jerusalem/Tel Aviv area of Israel;

provided, however, that the Executive may not terminate his employment under this Agreement for Good Reason unless he has given the Companies (i) written notice of the basis for the proposed termination given not more than thirty (30) days after the Executive has obtained knowledge of such basis ("Executive's Notice of Termination") and (ii) a period of at least thirty (30) days after the Companies' receipt of such notice in which to cure such basis.

- (e) Change in Control. The Executive may terminate this Agreement if there is a "Change in Control." For purposes of this Agreement, a "Change in Control" shall mean any of the following events:
  - (i) the acquisition (other than from Arotech in any public offering or private placement of equity securities) by any person or entity of beneficial ownership of twenty (20%) or more of the combined voting power of Arotech's then outstanding voting securities; or
  - (ii) individuals who, as of January 1, 2000, were members of the Board of Arotech (the "Original Arotech Board"), together with individuals approved by a vote of at least two-thirds (2/3) of the individuals who were members of the Original Arotech Board and are then still members of the Board of Arotech, cease for any reason to constitute at least one-third (1/3) of the Board of Arotech; or
  - (iii) approval by the shareholders of either of the Companies of a complete winding-up of such Company or an agreement for the sale or other disposition of all or substantially all of the assets of either of the Companies.

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The Executive shall give to the Companies an Executive's Notice of Termination if the Executive desires to terminate his employment because there has been a Change in Control, such notice to specify the date of such termination which shall be not less than thirty (30) days after such notice is received by the Companies. Any such notice, to be effective with respect to any Change in Control, must be sent no later than twenty-four (24) months after such Change in Control.

- (f) Termination Date, Etc. "Termination Date" shall mean in the case of the Executive's death, his date of death, or in all other cases, the date specified in the Notice of Termination subject to the following:

- (i) if the Executive's employment is terminated by the Companies for Cause or due to Disability, the date specified in the Companies' Notice of Termination shall be at least thirty (30) days from the date the Notice of Termination is given to the Executive, provided that in the case of Disability the Executive shall not have returned to the full-time performance of his duties during such period of at least thirty (30) days;
  - (ii) if the Executive's employment is terminated for Good Reason, or because there has been a Change in Control, the Termination Date specified in the Executive's Notice of Termination shall not be more than sixty (60) days from the date the Notice of Termination is given to the Companies.
- (g) Termination at Will. Subject to the other provisions of this Section 6, the Executive may terminate his employment with the Companies for any reason other than the other reasons specified in this Section 6 ("Termination at Will"), by giving to the Companies written Notice of Termination specifying the Termination Date, which Termination Date shall be at least one hundred and twenty (120) days from the date of such Notice of Termination.
7. Compensation upon Termination.

Upon termination of the Executive's employment hereunder, the Executive shall be entitled to the following benefits:

- (a) If the Executive's employment is terminated by the Companies for Cause or if the Executive's employment is terminated by the Executive other than with either Good Reason, because there has been a Change in Control, due to Non-Renewal, or due to Termination at Will, then the Companies shall pay the Executive all amounts of Base Salary and the employee benefits specified in clauses (a), (b) and (c) of Section 4 of this Agreement earned or accrued hereunder through the Termination Date but not paid as of the Termination Date (collectively, "Accrued Compensation").
- (b) If the Executive's employment by the Companies shall be terminated (1) due to Disability, (2) by the Executive for Good Reason, (3) by the Executive because there has been a Change in Control, (4) by the Executive's death, (5) due to Non-Renewal, or (6) due to Termination at Will, then the Executive shall be entitled to the benefits provided below (in addition to and not instead of whatever other benefits he may be entitled to by reason of operation of law):

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- (i) The Companies shall pay the Executive (a) all Accrued Compensation, (b) a bonus at a rate of the higher of (i) 35%, or (ii) the rate that would otherwise be payable pursuant to the provisions of Section 3(b) above for the year in which the Termination Date occurs, of Executive's annual Base Salary as of the Termination Date, pro rated based on the number of days in such year which occurred prior to the Termination Date, and (c) the amounts referred to in Sections 4(d) and (e) above, to the extent earned or accrued hereunder through the Termination Date but unpaid as of the Termination Date.
- (ii) the Companies shall pay into the Trust (as defined in Section 7(b)(v) below), as a retirement payment (the "Retirement Payment") and in lieu of any further salary for periods subsequent to the Termination Date (except as provided in Section 7(b)(i) above), a total of \$1,625,400 (the parties acknowledge that \$500,000 of this amount has previously been paid into the Trust (the "Pre-Payment")). Subject to the proviso contained in Section 7(b)(v) below, the Retirement Payment will vest and be funded into the Trust in four equal installments as provided in Section 7(b)(iii) below, and will be released from the Trust to the Employee as follows:
  - (a) In the event of termination due to Change of Control, the amount of the Retirement Payment will be doubled, and, notwithstanding the provisions of Section 7(b)(iii) below, all unvested and/or unfunded amounts of the doubled Retirement



Payment will vest immediately and become due and payable on the Termination Date.

(b) In the event of termination due to Good Reason, Disability, death or any other termination without Cause by the Companies, all unvested and/or unfunded installments of the Retirement Payment will, notwithstanding the provisions of Section 7(b)(iii) below, vest immediately and become due and payable on the Termination Date.

(c) In the event of termination due to Non Renewal or Termination at Will, the Employee will be entitled only to that portion of the Retirement Payment that shall have vested or shall vest prior to the Termination Date, which amount will become due and payable on the Termination Date.

(iii) The installments of the Retirement Payment will vest and (subject to the proviso contained in Section 7(b)(v) below) be funded as follows:

(a) First installment (vests upon signing of this Agreement): \$312,500 in cash and \$93,750 as a credit from the Pre-Payment;

(b) Second installment (vests on December 31, 2005): \$406,250 in cash;

(c) Third installment (vests on December 31, 2006): \$406,250 in cash; and

(d) Final installment (vests on December 31, 2007): \$406,250 as a credit from the Pre-Payment.

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(iv) For thirty-six (36) months, the Companies shall at their expense continue on behalf of the Executive and his dependents and beneficiaries all of the benefits, including without limitation manager's insurance, life insurance, disability, medical, dental and hospitalization benefits and use of an automobile, which were being provided to the Executive at the time Notice of Termination is given (or, if the Executive terminates his employment for Good Reason or because a Change in Control has occurred, the benefits provided to the Executive at the time immediately preceding when such Good Reason arose or such Change in Control occurred, if greater, or if such benefits are being provided after the Executive's death, the date of his death), provided that the Companies' obligation hereunder with respect to the foregoing benefits shall be limited to the extent that the Executive obtains any such benefits pursuant to a subsequent employer's benefit plans; and provided, further, that in the event of a contemplated Change of Control, an amount in cash equal to the cost of these benefits will be transferred to the Executive prior to the consummation of such Change of Control.

(v) The Companies have previously established a rabbi trust for the benefit of the Executive (the "Rabbi Trust"). The Companies will fund vested amounts of the Retirement Payment into the Trust as they vest; provided, however, that a vested amount will not be funded upon vesting if the CFO, the Audit Committee and the Compensation Committee of Arotech inform the Executive in writing and in good faith that they believe that such funding would jeopardize the Companies' cash position; any such deferred amount will be funded as soon as the cash position of the Companies permits such funding, and in any event upon the Termination Date. Once a payment is funded into the Trust the risk of gain or loss with respect to such payment passes to the Executive.

(c) The Companies shall procure life insurance on the Executive in order to secure the payment of its obligations arising in the event of termination under Section 6(a) hereof. Such insurance shall be payable to the Company, which shall remain primarily liable for the payment of all such obligations to the Executive.

- (d) All stock options that are unvested shall vest on Termination and all Options shall be extended for the longer of their term or the term by which Arotech director options are generally extended upon a director of Arotech leaving Arotech's Board of Directors.

As a condition to receiving the payments described in this Section 7, the Executive shall execute and deliver to the Companies a release in the form attached hereto as Exhibit A.

8. Confidentiality; Proprietary Rights; Competitive Activity.

- (a) Confidentiality. Executive recognizes and acknowledges that the technology, developments, designs, inventions, improvements, data, methods, trade secrets and works of authorship which the Companies own, plan or develop, including without limitation the specifications, documentation and other information relating to the Companies' zinc-air battery systems, and businesses and equipment related thereto (in each case whether for their own use or for use by their clients) are confidential and are the property of the Companies. Executive also recognizes that the Companies' technology, customer lists, supplier lists, proposals and procedures are confidential and are the property of the Companies. Executive further recognizes and acknowledges that in order to enable the Companies to perform services for their clients, those clients may furnish to the Companies confidential information concerning their business affairs, property, methods of operation or other data. All of these materials and information will be referred to below as "Proprietary Information"; provided, however, that such information shall not include any information known generally to the public (other than as a result of unauthorized disclosure by the Executive).

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- (b) Non-Disclosure. Executive agrees that, except as directed by the Companies, and in the ordinary course of the Companies' businesses, Executive will not during Executive's employment with the Companies and thereafter, disclose to any person or entity or use, directly or indirectly for Executive's own benefit or the benefit of others, any Proprietary Information, or permit any person to examine or make copies of any documents which may contain or be derived from Proprietary Information; provided, however, that the Executive's duties under this Section 8(b) shall not extend to (i) any disclosure that may be required by law in connection with any judicial or administrative proceeding or inquiry or (ii) any disclosure which may be reasonably required in connection with any actions or proceedings to enforce the Executive's rights under this Agreement. Executive agrees that the provisions of this paragraph shall survive the termination of this Agreement and Executive's employment by the Companies.
- (c) Competitive Activity. The Executive undertakes not, directly or indirectly (whether as owner, partner, consultant, employee or otherwise) at any time, during and for thirty-six (36) months following termination of his employment with the Companies, to engage in or contribute his knowledge to any work or activity that involves a product, process, service or development which is then directly (in any material manner) competitive with the Companies' zinc-air energy systems and the same as or similar to a product, process, service or development specifically related to the Companies' zinc-air energy system on which the Executive worked or with respect to which the Executive had access to Proprietary Information while with the Companies. Notwithstanding the foregoing, the Executive shall be permitted to engage in the aforementioned proposed work or activity if the Companies furnishes him with written consent to that effect signed by an authorized officer of each Company.
- (d) No Solicitation. During the period specified in 8(c) hereof, Executive will not solicit or encourage any customer or supplier of either Company or of any group, division or subsidiary of either Company, to terminate its relationship with either Company or any such group, division or subsidiary, and Executive will not, directly or indirectly, recruit or otherwise seek to induce any employee of either Company or any such group, division or subsidiary to terminate his or her employment or violate any agreement with or duty to either Company or any such group, division or subsidiary.

(e) Equitable Relief. The Executive agrees that violations of the material covenants in this Section 8 will cause the Companies irreparable injuries and agrees that the Companies may enforce said covenants by seeking injunctive or other equitable relief (in addition to any other remedies the Companies may have at law for damages or otherwise) from a court of competent jurisdiction. In the event such court declares these covenants to be too broad to be specifically enforced, the covenants shall be enforced to the largest extent as may be allowed by such court for the Companies' protection. Executive further agrees that no breach by the Companies of, or other failure by the Companies under this Agreement shall relieve the Executive of any obligations under Sections 8(a) and 8(b) hereof.

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9. Successors and Assigns.

(a) This Agreement shall be binding upon and shall inure to the benefit of each Company, its successors and assigns and the Companies shall require any successor or assign to expressly assume and agree to perform this Agreement in the same manner and to the same extent that the Companies would be required to perform it if no such succession or assignment had taken place. The term the "Companies" as used herein shall include such successors and assigns. The term "successors and assigns" as used herein shall mean a corporation or other entity acquiring all or substantially all the assets and business of either Company (including this Agreement) whether by operations of law or otherwise.

(b) Subject to Section 16 hereof, neither this Agreement nor any right or interest hereunder shall be assignable or transferable by the Executive, his beneficiaries or legal representatives, except by will or by the laws of descent and distribution. This Agreement shall inure to the benefit of and be enforceable by the Executive's legal personal representative.

10. Notice.

For the purposes of this Agreement, notices and all other communications provided for in the Agreement shall be in writing and shall be deemed to have been duly given when personally delivered or sent by registered mail, postage prepaid, addressed to the respective addresses set forth below or last given by each party to the other. All notices and communications shall be deemed to have been received on the date of delivery thereof or on the eighth business day after the mailing thereof, except that notice of change of address shall be effective only upon receipt.

The initial addresses of the parties for purposes of this Agreement shall be as follows:

The Companies:           Arotech Corporation  
                              354 Industry Drive  
                              Auburn, Alabama 36830  
                              Attention: Steven Esses, Executive Vice President

and                         Electric Fuel Limited  
                              Western Industrial Park  
                              P.O. Box 461  
                              Beit Shemesh 99000  
                              Israel

The Executive:           Robert S. Ehrlich  
                              21 Nahal Sorek  
                              Ramat Beit Shemesh  
                              Israel

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11. Miscellaneous.

No provision of this Agreement may be modified, waived or discharged unless such waiver, modification or discharge is agreed to in writing and signed by the

Executive and the Companies. No waiver by either party hereto at any time of any breach by the other party hereto of, or compliance with, any condition or provision of this Agreement to be performed by such other party shall be deemed a waiver of similar or dissimilar provisions or conditions at the same or at any prior or subsequent time. No agreement or representations, oral or otherwise, express or implied, with respect to the subject matter hereof have been made by either party which are not expressly set forth in this Agreement.

12. Governing Law; Venue.

This Agreement shall be governed by and construed and enforced in accordance with the laws of Israel without application of any conflicts of laws principles which would cause the application of the domestic substantive laws of any other jurisdiction. Each of the Executive and the Companies hereby irrevocably waives any objection it may now or hereafter have to the laying of venue in the courts of the State of Israel for any legal suit or action instituted by any party to the Agreement against any other with respect to the subject matter hereof.

13. Severability.

The provisions of this Agreement shall be deemed severable, and the invalidity or unenforceability of any provision shall not affect the validity or enforceability of the other provisions hereof.

14. Entire Agreement.

This Agreement constitutes the entire agreement between the parties hereto and supersedes all prior agreements, understandings and arrangements, oral or written, between the parties hereto with respect to the subject matter hereof including, without limitation the Original Agreement.

15. Joint and Several Obligations.

The obligations and liabilities of each Company hereunder shall be joint and several with the obligations and liabilities of the other Company hereunder.

16. Registration Rights.

- (a) If Arotech at any time proposes to register any of its securities under the Securities Act of 1933, as from time to time in effect (together with the rules and regulations thereunder, all as from time to time in effect, the "Securities Act"), for its own account or for the account of any holder of its securities, on a form which would permit registration of Common Stock of Arotech at the time held or obtainable upon the exercise of options, warrants or rights, or the conversion of convertible securities, at the time held by the Executive ("Registrable Securities"), for sale to the public under the Securities Act, Arotech will each such time give notice to the Executive of its intention to do so. Such notice shall describe such securities and specify the form, manner and other relevant aspects of such proposed registration. The Executive may, by written response delivered to Arotech within 15 days after the giving of any such notice, request that all or a specified part of the Registrable Securities be included in such registration. Arotech will thereupon use its best efforts as part of its filing of such form to effect the registration under the Securities Act of all Registrable Securities which Arotech has been so requested to register by the Executive, to the extent required to permit the disposition (in accordance with the intended methods thereof as aforesaid) of the Registrable Securities to be so registered.

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- (b) The Executive may, by notice to Arotech specifying the intended method or methods of disposition, given at any time and from time to time after Arotech has registered any shares of its Common Stock under the Securities Act, request that Arotech effect the registration under the Securities Act of all or a specified part of the Registrable Securities; provided, however, that Arotech shall not be required to effect a registration pursuant to this Section 16(b) unless such registration may be effected on a Form S-3 (or any successor or similar Form); and provided, further, that each registration pursuant to this Section 16(b) shall cover a number of Registrable Shares equal to not less than 2% of the aggregate number of

shares of Arotech Common Stock then outstanding. Arotech will then use its best efforts to effect the registration as promptly as practicable under the Securities Act of the Registrable Securities which Arotech has been requested to register by the Executive pursuant to the Section 16(b).

- (c) Notwithstanding the provisions of Section 16(b), in the event that Executive has requested pursuant to Section 16(b) that Arotech effect a registration of securities, and (i) the Board of Arotech determines that it would be seriously detrimental to Arotech to effect a registration pursuant to Section 16(b), or (ii) the Board of Arotech determines in good faith that (A) Arotech is in possession of material, non-public information concerning an acquisition, merger, recapitalization, consolidation, reorganization or other material transaction by or of Arotech or concerning pending or threatened litigation and (B) disclosure of such information would jeopardize any such transaction or litigation or otherwise materially harm Arotech, then Arotech shall promptly notify Executive of the occurrence of any of the events described in the foregoing clauses (i) or (ii). Upon the occurrence of any of the events described in clauses (i) or (ii) hereof, Arotech shall be allowed to defer a registration of securities pursuant to Section 16(b) above, and if a registration statement had already been filed at such time, Executive shall not dispose of his Registrable Securities under such registration statement until it is so advised in writing by Arotech that the registration of securities under 16(b) may be effected or resumed. Notwithstanding the foregoing, any such deferment or prohibition on disposition shall not be in effect for more than 90 days in any 12 months period.
- (d) Arotech shall not be obligated to effect any registration of Registrable Securities under Section 16(a) hereof incidental to the registration of any of its securities in connection with mergers, acquisitions, exchange offers, dividend reinvestment plans or stock option or other employee benefit plans.
- (e) Arotech hereby agrees to pay, or cause to be paid, all legal, accounting, printing and other expenses (other than the fees and expenses of the Executive's own counsel and other than underwriting discounts and commissions attributable to the Registrable Securities) in connection with each registration of Registrable Securities pursuant to this Section 16.

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- (f) In connection with each registration of Registrable Securities pursuant to this Section 16, Arotech and the Executive will enter into such agreements, containing such terms and conditions, as are customary in connection with public offerings, such agreements to contain, without limitation, customary indemnification provisions, representations and warranties and opinions and other documents to be delivered in connection therewith, and to be, if requested, with underwriters.
- (g) The provisions of this Section 16 shall be subject to any agreement entered into by Arotech, in good faith, with any underwriter of Arotech's securities or any person or entity providing financing to Arotech, in each case containing reasonable limitations on the Executive's rights and Arotech's obligations hereunder.
- (h) The provisions of this Section 16 shall survive the termination of the other provisions of this Agreement. The rights of the Executive under this Section 16 are assignable, in whole or in part, by the Executive to any person or other entity acquiring securities of Arotech from the Executive.
- (i) Notwithstanding anything in the foregoing to the contrary, the Executive shall not demand a registration during the 180 days following an underwritten public offering of the Common Stock of the Company.
- (j) Without the prior written consent of the underwriters managing any public offering, for a period beginning ten days immediately preceding the effective date of any registration statement filed by the Company under the Securities Act of 1933, as amended, and ending on the earlier of (i) 180 days after the effective date of such registration statement and (ii) the end of the shortest period generally applicable to any "affiliate" (as defined in the Securities Act of 1933, as amended) of Arotech who is a

selling shareholder pursuant to such registration statement or who is otherwise subject to a lockup provision, the Executive (whether or not a selling shareholder pursuant to such registration statement) shall not sell or otherwise transfer any securities of Arotech except pursuant to such registration statement.

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IN WITNESS WHEREOF, the Companies have caused this Agreement to be executed by its duly authorized officer and the Executive has executed this Agreement as of the day and year first above written.

AROTECH CORPORATION

By: \_\_\_\_\_  
Its: Executive Vice President and COO

ELECTRIC FUEL (E.F.L.) LIMITED

By: \_\_\_\_\_  
Its: President and CEO Executive

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Exhibit A

FORM OF MUTUAL RELEASE

This mutual release is executed and delivered by and between the undersigned employee of Arotech Corporation, a Delaware corporation ("Arotech") and Electric Fuel (E.F.L.) Limited ("EFL") and the undersigned's successors, assigns, executors, estates and personal representatives (collectively, the "Executive"), on the one hand, and Arotech and EFL and each of their respective affiliates, agents, successors and assigns (collectively, the "Companies"), on the other hand. For and in consideration of the Executive receiving the compensation referred to in Section 7 of the Third Amended and Restated Employment Agreement effective as of January 1, 2005 and other good and valuable consideration, the adequacy and receipt of which are hereby acknowledged by the Executive and the Companies, the Executive hereby remises, releases and forever discharges the Companies, and the Companies hereby remise, release and forever discharge the Executive, of and from any and all manner of action and actions, cause and causes of actions, suits, debts, dues, sums of money, accounts, reckonings, bonds, bills, covenants, contracts, controversies, executions, claims and demands of any kind and nature whatsoever in law or in equity, known or unknown, against the other party which ever existed prior to the date hereof, or may ever have on and after the date hereof with respect to matters arising, and dealings with the other party occurring, prior to the date hereof; provided, however, that nothing contained herein shall be construed to release the Executive from any obligations to the Companies pursuant to the Employment Agreement nor to release the Companies from any of their obligations to the Executive pursuant to the Employment Agreement.

IN WITNESS WHEREOF, the Executive and the Companies have each caused this Release to be executed as of \_\_\_\_\_.

EXECUTIVE

-----  
Name: Robert S. Ehrlich

AROTECH CORPORATION

By: \_\_\_\_\_  
Title:

ELECTRIC FUEL (E.F.L.) LTD.

By: \_\_\_\_\_  
Title:

## EMPLOYMENT AGREEMENT

THIS AGREEMENT ("Agreement") is signed on the 15th day of May, 2005, effective as of the 1st day of January, 2005, and is entered into by and among Electric Fuel (E.F.L.) Ltd., an Israeli corporation (the "Company"), and Mr. Steven Esses (the "Executive").

WHEREAS, the Company wishes to employ the Executive, and the Executive wishes to be employed by the Company, on the terms and conditions hereinafter set forth;

NOW, THEREFORE, in consideration of the respective agreements of the parties contained herein, the parties agree as follows:

### 1. Term.

The term of the Executive's employment under this Agreement shall be for the period commencing on January 1, 2005, and ending on December 31, 2006 (the "Initial Term"), provided, however, that the term of this Agreement shall be automatically extended for additional terms of two (2) years each (each, an "Additional Term") upon the end of the Initial Term and each Additional Term, unless either the Executive or the Company shall have given written notice to the other at least ninety days (90) days prior thereto that the term of this Agreement shall not be so extended (a "Non-Renewal"). The provisions of this Agreement shall apply to the relationship between the parties hereto retroactively as if this Agreement were signed on the commencement of the Initial Term.

### 2. Employment.

- (a) The Executive shall be employed as Executive Vice President and Chief Operating Officer of the Company. The Executive shall perform the duties, undertake the responsibilities and exercise the authority customarily performed, undertaken and exercised by persons situated in a similar executive capacity in Israeli subsidiaries of publicly-held corporations. The Executive shall exercise his authority in a reasonable manner and shall report to the Chief Executive Officer of the Company (the "CEO").
- (b) Excluding periods of vacation and sick leave to which the Executive shall be entitled, the Executive agrees to devote the attention and time to the businesses and affairs of the Company required to discharge the responsibilities assigned to the Executive hereunder. The Company acknowledges that the Executive is a director of multiple non-profit organizations. In addition, the Company acknowledges that the Executive is involved in certain investment activities which, together with the above mentioned positions, will consume a portion of his time. The Company consents to these other positions and activities so long as these do not interfere in any material manner with the Executive's performance of his duties hereunder and do not constitute a violation of Section 8 hereof.
- (c) While the Executive is employed by the Company hereunder, the Company shall use its best efforts to cause the Executive to be elected to the Board of Directors of the Company (the "Board") and on the board of directors of such of the Company's Israeli subsidiaries as the CEO shall determine, as a member of such Board(s).
- (d) The Company will use its reasonable best efforts to obtain, and to keep in place at all times that the Executive is a director or officer of the Company, a directors and officers liability policy covering the Executive in an amount and otherwise containing terms and conditions consistent with past practices.
- (e) The Executive agrees to serve on the Board and on the board of directors of such Israeli subsidiaries of the Company as the CEO may request.
- (f) The Executive shall be required to travel on a periodic basis. Air travel shall be business class.

### 3. Base Salary, Bonus and Financial Planning Allowance.



(a) Base Salary. The Company agrees to pay or cause to be paid to the Executive, for his services to the Company, during the first year of this Agreement a base salary at the rate of US \$5,000 per month, or such larger amount as the Compensation Committee of the Board (the "Compensation Committee") may in its sole discretion determine following a review which shall be conducted by the CEO and the Compensation Committee by not later than March 31 of each year, such larger amount to take effect retroactively to the January 1 immediately preceding such review (hereinafter referred to as the "Base Salary"). Such Base Salary shall be payable in equal monthly installments.

(b) Bonus. The Company will pay or cause to be paid to the Executive a signing bonus of up to \$100,000, payable at the end of each fiscal quarter in eight equal quarterly installments of \$12,500 each during the term of this Agreement, with each such payment being contingent on the Executive being employed by the Company on the scheduled payment date. Additionally, the Company agrees to pay or cause to be paid to the Executive on each anniversary of this Agreement or as soon thereafter as may be possible in order to determine the relevant results of the Company, an annual bonus, as follows:

(i) If, as of such anniversary, the Company shall have attained 90% of the Company's Budgeted Number (as defined below) for the year preceding such anniversary, then Executive's bonus shall be equal to 25% of Executive's gross annual Base Salary as then in effect for the year preceding such anniversary;

(ii) If, as of such anniversary, the Company shall have attained 120% of the Company's Budgeted Number (as defined below) for the year preceding such anniversary, then Executive's bonus shall be equal to 75% of Executive's gross annual Base Salary as then in effect for the year preceding such anniversary;

(iii) If, as of such anniversary, the Company shall have attained more than 90% but less than 120% of the Company's Budgeted Number (as defined below), then Executive's bonus shall be calculated as follows:

$$B = (S \times 25\%) + (N-90)/30 \times (S \times 50\%)$$

Where:

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B = The amount of Executive's annual bonus, as a percentage of Executive's gross annual Base Salary; and

N = The percentage of the Budgeted Number (as defined below) that was attained by the Company in the immediately preceding fiscal year; provided, however, that N is more than 90 and less than 120;

S = Executive's gross annual Base Salary;

provided, however, that the Executive shall be entitled in each year to a minimum bonus of 20% of his salary.

For the purposes of this Section 3(b), the Budgeted Number shall be the budgeted results of the Company as agreed by the Board prior to the end of each fiscal year for the fiscal year designated in such budget, and may include targets for any or all of the following factors: (i) revenues; (ii) cash flow, and (iii) EBITDA. In the event that some but not all targets are reached, the Compensation Committee shall make a determination as to what percentage of the Budgeted Number was attained.

(c) Stock Options. The Executive will receive annual stock option bonus grants for options to purchase the common stock of the Company's parent corporation, Arotech Corporation ("Arotech"), in amounts to be determined based on the recommendation of the CEO and the decision of the Compensation Committee of Arotech. Notwithstanding anything in any stock option grant to the contrary, all stock options granted to the Executive shall be exercisable after termination of the Executive's employment for any reason other than for Cause (as hereinafter defined) for a period of

time equal to the term by which Arotech director options are generally extended upon a director of Arotech leaving Arotech's Board of Directors.

- (d) Tax Planning Reimbursement. The Company shall pay Executive an amount of up to \$10,000 on the first anniversary of this Agreement and up to \$7,500 on each subsequent anniversary of this Agreement to cover Executive's legal, tax and financial planning expenses, against invoices or receipts. Any amounts not used in a given year shall roll over to future years, but amounts unused at notice of termination of this Agreement shall expire. Legal expenses may not be used to finance legal advice or litigation against the interests of the Company.

#### 4. Employee Benefits.

The Executive shall be entitled to the following benefits:

- (a) Life and Disability Insurance. The Company will pay to an insurance company of the Executive's choice, as premiums for life and disability insurance for the Executive, an amount equal to 13.33% of each monthly payment of the Base Salary together with 2.5% of the Base Salary for disability, and will deduct from each monthly payment of the Base Salary and pay to such insurance company an amount equal to 5% of each monthly payment of the Base Salary, which shall constitute the Executive's contribution to such premiums. Upon the termination of the Executive's employment with the Company for whatever reason, including without limitation termination for Cause or the resignation by the Executive, the right to receive the life and disability insurance benefits shall be automatically assigned to the Executive. At the Executive's option, in lieu of providing life and disability insurance, the Company shall pay the amount it would otherwise pay for such insurance to the trust referred to in Section 7(b) (ii) hereof.

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- (b) Education Fund. The Company will contribute to an education fund of the Executive's choice an amount equal to 7.5% of each monthly payment of the Base Salary, and will deduct from each monthly payment of the Base Salary and contribute to such education fund an additional amount equal to 2.5% of each such monthly payment of the Base Salary. Additionally, the Company will pay a supplementary amount to the education fund in the amount of 20% of the Base Salary. Upon the termination of the Executive's employment with the Company for whatever reason, including without limitation termination for Cause or the resignation by the Executive, the right to receive any amounts in such fund shall be automatically assigned to the Executive. All education fund contributions or imputed income made under this Section in excess of the statutory exemption shall be tax-effected such that the amount of contribution net of any taxes and withholding (including such amounts in respect of payments pursuant to this sentence) equals the percentages specified herein.
- (c) Vacation. The Executive shall be entitled to an annual vacation at full pay equal to 24 work days. Vacation days may be accumulated and may, at the Executive's option or automatically upon termination, be converted into cash payments in an amount equal to the proportionate part of the Base Salary for such days; provided, however, that if the Executive accumulates more than two (2) times his then current annual entitlement of vacation days, such excess shall be automatically converted into the right to receive such a cash payment in respect of such excess. Payments to which the Executive is entitled pursuant to this Section 4(c) shall be made promptly after the Executive's request therefor.
- (d) Sick Leave. The Executive shall be entitled to a maximum aggregate of 30 days of fully paid sick leave, accruing at the rate of 2.5 days per month; provided, however, that the Executive shall not be entitled to sick leave payment to the extent he is already covered by manager's insurance. Sick leave may be accumulated and may, at the Executive's option, be converted into cash payments in an amount equal to the proportionate part of the Base Salary for such days. Payments to which the Executive is entitled pursuant to this Section 4(d) shall be made promptly after the Executive's request therefor.
- (e) Automobile. Every three years, the Company shall make a new automobile

available to the Executive during the term of this Agreement. Such automobile shall be of a high quality comparable to, but not less than, that of a current (2003, with respect to the Initial Term) model Honda Accord, Volkswagen Passat or Audi A4, and shall be subject to the approval of the Executive, which shall not be unreasonably withheld. The Executive shall be entitled to use the automobile for his personal and business needs, so long as he does not allow anyone who would not be covered by the Company's insurance to drive it. The Company shall pay all expenses of maintaining and operating the automobile. All expense reimbursements or imputed income made under this Section shall be tax-effected such that the amount of reimbursement received by the Executive net of any taxes and withholdings (including such amounts in respect of payments pursuant to this sentence) equals the expense incurred.

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- (f) Benefit Plans. The Executive shall be entitled to participate in all incentive, bonus, benefit or other similar plans offered by the Company, including without limitation the Company's 2004 Stock Option and Restricted Stock Purchase Plan, in accordance with the terms thereof and as determined by the Board from time to time.

5. Expenses.

The Executive shall be entitled to receive prompt reimbursement of all expenses reasonably incurred by him in connection with the performance of his duties hereunder. Without limiting the generality of the foregoing, the Company shall pay all of the Executive's expenses in the use of Internet and telephones for the Company's businesses. The Executive shall be entitled to receive room, board and travel reimbursement in connection with the performance of his duties other than at the principal executive office of the Company, as is customary for senior executives of publicly-held companies. All expense reimbursements made under this Section shall be tax-effected such that the amount of reimbursement received by the Executive net of any taxes and withholdings (including such amounts in respect of payments pursuant to this sentence) equals the expense incurred.

6. Termination.

The Executive's employment hereunder shall and/or may be terminated under the following circumstances:

- (a) Death. This Agreement shall terminate upon the death of the Executive.
- (b) Disability. The Company may terminate the Executive's employment after having established the Executive's Disability. For purposes of this Agreement, "Disability" means a physical or mental infirmity which impairs the Executive's ability to substantially perform his duties under this Agreement which continues for a period of at least one hundred and eighty (180) consecutive days.
- (c) Cause. The Company may terminate the Executive's employment for Cause. For purposes of this Agreement, termination for "Cause" shall mean and include: (i) conviction for fraud, crimes of moral turpitude or other conduct which reflects on the Company in a material and adverse manner; (ii) a willful failure to carry out a material directive of the CEO, provided that such directive concerned matters within the scope of the Executive's duties, was in conformity with Sections 2(a) and 2(b) hereof, would not give the Executive Good Reason to terminate this Agreement and was capable of being reasonably and lawfully performed; (iii) conviction in a court of competent jurisdiction for embezzlement of funds of the Company; and (iv) reckless or willful misconduct that is materially harmful to the Company; provided, however, that the Company may not terminate the Executive for Cause unless they have given the Executive written notice of the basis for the proposed termination ("Company's Notice of Termination").

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- (d) Good Reason. The Executive may terminate his employment under this Agreement for Good Reason. For purposes of this Agreement, "Good Reason"

shall mean the occurrence of any of the events or conditions described in subsections (i) through (vi) hereof:

- (i) a change (1) in the Executive's status, title, position or responsibilities which, in the Executive's reasonable judgment, represents a reduction or demotion in the Executive's status, title, position or responsibilities as in effect immediately prior thereto, or (2) in the primary location from which the Executive shall have conducted his business activities during the 60 days prior to such change;
- (ii) a reduction in the Executive's Base Salary;
- (iii) the failure by the Company to continue the Executive as a participant in any material compensation or benefit plan in which the other vice presidents of the Company are participating unless agreed to by the Executive;
- (iv) the insolvency or the filing (by any party, including the Company) of a petition for the winding-up of the Company;
- (v) any material breach by the Company of any provision of this Agreement;
- (vi) any purported termination of the Executive's employment for Cause by the Company which does not comply with the terms of Section 6(c) of this Agreement;

provided, however, that the Executive may not terminate his employment under this Agreement for Good Reason unless he has given the Company (i) written notice of the basis for the proposed termination not more than thirty (30) days after the Executive has obtained knowledge of such basis ("Executive's Notice of Termination") and (ii) a period of at least thirty (30) days after the Company's receipt of such notice in which to cure such basis.

(e) Change in Control. The Executive may terminate this Agreement if there is a "Change in Control." For purposes of this Agreement, a "Change in Control" shall mean any of the following events:

- (i) the acquisition (other than from the Company in any public offering or private placement of equity or equivalent securities) by any person or entity of beneficial ownership of thirty percent (30%) or more of the combined voting power of the Company's then outstanding voting securities; or
- (ii) individuals who, as of January 1, 2004, were members of the Board of the Company (the "Original Board"), together with individuals approved by a vote of at least two-thirds (2/3) of the individuals who were members of the Original Board and are then still members of the Board of the Company, cease for any reason to constitute at least one-third (1/3) of the Board of the Company; or

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(iii) approval by the shareholders of the Company of a complete winding-up of the Company or an agreement for the sale or other disposition of all or substantially all of the assets of the Company.

The Executive shall give to the Company an Executive's Notice of Termination if the Executive desires to terminate his employment because there has been a Change in Control, such notice to specify the date of such termination which shall be not less than thirty (30) days after such notice is received by the Company. Any such notice, to be effective with respect to any Change in Control, must be sent no later than six (6) months after such Change in Control.

(f) Termination Date, Etc. "Termination Date" shall mean in the case of the Executive's death, his date of death, or in all other cases, the date specified in the Notice of Termination subject to the following:

- (i) if the Executive's employment is terminated by the Company for Cause

or due to Disability, the date specified in the Company's Notice of Termination shall be at least thirty (30) days from the date the Notice of Termination is given to the Executive, provided that in the case of Disability the Executive shall not have returned to the full-time performance of his duties during such period of at least thirty (30) days;

(ii) if the Executive's employment is terminated for Good Reason, or because there has been a Change in Control, the Termination Date specified in the Executive's Notice of Termination shall not be more than sixty (60) days from the date the Notice of Termination is given to the Company.

(g) Retirement. At any time during the period beginning (i) 150 days prior to his 65th birthday ("Retirement") or (ii) from 150 days prior to his 55th birthday until 150 days prior to his 65th birthday ("Early Retirement"), the Executive may retire from his positions with the Companies by giving to the Companies written Notice of Retirement specifying the Retirement Date, which Retirement Date shall be at least one hundred and fifty (150) days from the date of such Notice of Retirement.

#### 7. Compensation upon Termination.

Upon termination of the Executive's employment hereunder, the Executive shall be entitled to the following benefits:

(a) If the Executive's employment is terminated by the Company for Cause or if the Executive's employment is terminated by the Executive other than with either Good Reason, because there has been a Change in Control, due to Non-Renewal, or due to Retirement or Early Retirement, then the Company shall pay the Executive all amounts of Base Salary and the employee benefits specified in clauses (a), (b) and (c) of Section 4 of this Agreement earned or accrued hereunder through the Termination Date but not paid as of the Termination Date (collectively, "Accrued Compensation").

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(b) If the Executive's employment by the Company shall be terminated (1) due to Disability, (2) by the Executive for Good Reason, (3) by the Executive because there has been a Change in Control, (4) by the Executive's death, (5) due to Non-Renewal or (6) due to Retirement or Early Retirement, then the Executive shall be entitled to the additional benefits provided below:

(i) the Company shall pay the Executive (a) all Accrued Compensation, (b) a bonus at a rate of the higher of (i) 20%, or (ii) the rate that would otherwise be payable pursuant to the provisions of Section 3(b) above for the year in which the Termination Date occurs, of Executive's annual Base Salary as of the Termination Date, pro rated based on the number of days in such year which occurred prior to the Termination Date, and (c) the amounts referred to in Sections 4(d) and (e) above, to the extent earned or accrued hereunder through the Termination Date but unpaid as of the Termination Date;

(ii) the Company shall pay into a trust to be established pursuant to a separate trust agreement (the "Trust") as termination pay (in lieu of any amounts payable as severance under law) and in lieu of any further salary for periods subsequent to the Termination Date (except as provided in Section 7(b)(i) above), a total of \$330,000; provided, however, that if the Executive's employment is terminated by reason of a Change of Control or a change in the primary location from which the Executive shall have conducted his business activities during the 60 days prior to such change, the termination payment pursuant to this clause (y) shall be an amount equal to twice the amount that would otherwise be payable. Termination pay will vest and be funded into the Trust in three equal installments as provided in Section 7(b)(iv) below.

(iii) for a period of time equal to (1) twelve months, in the case of Termination due to Disability, Good Reason, a Change in Control, the Executive's death, or Non-Renewal, or (2) twenty-four months, in the case of Termination due to Early Retirement, or (3) thirty-six

months, in the case of Termination due to Retirement, the Company shall at its expense continue on behalf of the Executive and his dependents and beneficiaries all of the benefits, including without limitation automobile (only in the case of Retirement or Early Retirement), manager's insurance, life insurance, disability, medical, dental and hospitalization benefits, which were being provided to the Executive at the time Notice of Termination is given (or, if the Executive terminates his employment for Good Reason or because a Change in Control has occurred, the benefits provided to the Executive at the time immediately preceding when such Good Reason arose or such Change in Control occurred, if greater, or if such benefits are being provided after the Executive's death, the date of his death), provided that the Company's obligation hereunder with respect to the foregoing benefits shall be limited to the extent that the Executive obtains any such benefits pursuant to a subsequent employer's benefit plans.

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- (iv) The termination pay will be funded into the Trust in three equal installments, each in an amount in cash equal to \$110,000. The first installment will be paid into the Trust on signing of this Agreement, the second by December 31, 2005, and the third by December 31, 2006.
- (v) In the event of a termination due to Change of Control or a change in the primary location from which the Executive shall have conducted his business activities during the 60 days prior to such change, all of the Executive's stock options, whether or not they have yet vested, shall immediately vest and shall be extended for a period of the later of (x) the expiration date thereof, and (y) the second anniversary of such Change of Control or change in location. In the event of termination due to any other reason except for Termination for Cause, the Executive's then-vested stock options shall be extended for a period of the earlier of (x) the expiration date thereof, and (y) two years after such termination.

Such sums are intended to be in place of and not in addition to any severance sums due to the Executive by operation of law, and any such sums paid to the Executive as a result of statutory or other legal requirements shall be deducted from the sums above. Such sums are not intended to be in lieu of amounts payable pursuant to any separate agreements entered into contemporaneously with or subsequent to the date of this Agreement.

As a condition to receiving the payments described in this Section 7, the Executive shall execute and deliver to the Company a release in the form attached hereto as Exhibit A.

8. Confidentiality; Proprietary Rights; Competitive Activity.

- (a) Confidentiality. Executive recognizes and acknowledges that the technology, developments, designs, inventions, improvements, data, methods, trade secrets and works of authorship which the Company owns, plans or develops, including without limitation the specifications, documentation and other information relating to the Company's zinc-air battery systems, and businesses and equipment related thereto (in each case whether for their own use or for use by their clients) are confidential and are the property of the Company. Executive also recognizes that the Company's technology, customer lists, supplier lists, proposals and procedures are confidential and are the property of the Company. Executive further recognizes and acknowledges that in order to enable the Company to perform services for its clients, those clients may furnish to the Company confidential information concerning their business affairs, property, methods of operation or other data. All of these materials and information will be referred to below as "Proprietary Information"; provided, however, that such information shall not include any information known generally to the public (other than as a result of unauthorized disclosure by the Executive).
- (b) Non-Disclosure. Executive agrees that, except as directed by the Company, and in the ordinary course of the Company's business, Executive will not during Executive's employment with the Company and thereafter, disclose to

any person or entity or use, directly or indirectly for Executive's own benefit or the benefit of others, any Proprietary Information, or permit any person to examine or make copies of any documents which may contain or be derived from Proprietary Information; provided, however, that the Executive's duties under this Section 8(b) shall not extend to (i) any disclosure that may be required by law in connection with any judicial or administrative proceeding or inquiry or (ii) any disclosure which may be reasonably required in connection with any actions or proceedings to enforce the Executive's rights under this Agreement. Executive agrees that the provisions of this paragraph shall survive the termination of this Agreement and Executive's employment by the Company.

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- (c) **Competitive Activity.** The Executive undertakes not, directly or indirectly (whether as owner, partner, consultant, employee or otherwise) at any time, during and for twelve (12) months following termination of his employment with the Company, to engage in or contribute his knowledge to any work or activity that involves a product, process, service or development which is then directly (in any material manner) competitive with any business that the Company has conducted during the term of this Agreement or any extension hereof on which the Executive worked or with respect to which the Executive had access to Proprietary Information while with the Company. Notwithstanding the foregoing, the Executive shall be permitted to engage in the aforementioned proposed work or activity if the Company furnishes him with written consent to that effect signed by an authorized officer of the Company.
- (d) **No Solicitation.** During the period specified in 8(c) hereof, Executive will not solicit or encourage any customer or supplier of the Company or of any group, division or subsidiary of the Company, to terminate its relationship with the Company or any such group, division or subsidiary, and Executive will not, directly or indirectly, recruit or otherwise seek to induce any employee of the Company or any such group, division or subsidiary to terminate his or her employment or violate any agreement with or duty to the Company or any such group, division or subsidiary.
- (e) **Equitable Relief.** The Executive agrees that violations of the material covenants in this Section 8 will cause the Company irreparable injuries and agrees that the Company may enforce said covenants by seeking injunctive or other equitable relief (in addition to any other remedies the Company may have at law for damages or otherwise) from a court of competent jurisdiction. In the event such court declares these covenants to be too broad to be specifically enforced, the covenants shall be enforced to the largest extent as may be allowed by such court for the Company's protection. Executive further agrees that no breach by the Company of, or other failure by the Company under this Agreement shall relieve the Executive of any obligations under Sections 8(a) and 8(b) hereof.

#### 9. Successors and Assigns.

- (a) This Agreement shall be binding upon and shall inure to the benefit of the Company, its successors and assigns and the Company shall require any successor or assign to expressly assume and agree to perform this Agreement in the same manner and to the same extent that the Company would be required to perform it if no such succession or assignment had taken place. The term the "Company" as used herein shall include such successors and assigns. The term "successors and assigns" as used herein shall mean a corporation or other entity acquiring all or substantially all the assets and business of the Company (including this Agreement) whether by operations of law or otherwise.

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- (b) Neither this Agreement nor any right or interest hereunder shall be assignable or transferable by the Executive, his beneficiaries or legal representatives, except by will or by the laws of descent and distribution. This Agreement shall inure to the benefit of and be enforceable by the Executive's legal personal representative.

(c) Nothing to the contrary in the foregoing notwithstanding, the Executive may assign this Agreement to any company of which he is a "control person" within the meaning of the Securities Exchange Act of 1934, provided, that the Executive shall continue to be obligated to fulfill the duties set forth in Section 2 above, and provided, further, that the Executive shall continue to be bound by the terms and provisions of Section 8 of this Agreement notwithstanding any such assignment.

#### 10. Notice.

For the purposes of this Agreement, notices and all other communications provided for in the Agreement shall be in writing and shall be deemed to have been duly given when personally delivered or sent by registered mail, postage prepaid, addressed to the respective addresses set forth below or last given by each party to the other. All notices and communications shall be deemed to have been received on the date of delivery thereof or on the eighth business day after the mailing thereof, except that notice of change of address shall be effective only upon receipt.

The initial addresses of the parties for purposes of this Agreement shall be as follows:

The Company:                   Electric Fuel (E.F.L.) Ltd.  
One HaSolela Street, Western Industrial Park  
Beit Shemesh 99000, Israel

The Executive:                 Steven Esses  
P.O. Box 1307  
Efrat, Israel

#### 11. Miscellaneous.

No provision of this Agreement may be modified, waived or discharged unless such waiver, modification or discharge is agreed to in writing and signed by the Executive and the Company. No waiver by either party hereto at any time of any breach by the other party hereto of, or compliance with, any condition or provision of this Agreement to be performed by such other party shall be deemed a waiver of similar or dissimilar provisions or conditions at the same or at any prior or subsequent time. No agreement or representations, oral or otherwise, express or implied, with respect to the subject matter hereof have been made by either party which are not expressly set forth in this Agreement.

#### 12. Governing Law; Arbitration; Venue.

This Agreement shall be governed by and construed and enforced in accordance with the laws of Israel without application of any conflicts of laws principles which would cause the application of the domestic substantive laws of any other jurisdiction. All disputes under this Agreement that cannot be resolved by the parties shall be submitted to arbitration under the rules and regulations of the Israel Institute of Commercial Arbitration. Either party may invoke this paragraph after providing 30 (thirty) days written notice to the other party. All costs of arbitration shall be divided equally between the parties. The arbitrator(s) shall award to the prevailing party, if any, as determined by the arbitrator(s), all of its costs and fees. "Costs and Fees" means all reasonable pre-award expenses of the arbitration, including arbitration fees, administrative fees, travel expenses, out-of-pocket expenses such as copying and telephone, court costs, witness fees and reasonable attorneys' fees. In the event that notwithstanding the foregoing arbitration provision there is nevertheless litigation in respect of this Agreement, each of the Executive and the Company hereby irrevocably waives any objection it may now or hereafter have to the laying of venue in the courts of the State of Israel, City of Tel-Aviv-Yafo, for any legal suit or action instituted by any party to the Agreement against any other with respect to the subject matter hereof.

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#### 13. Severability.

The provisions of this Agreement shall be deemed severable, and the invalidity or unenforceability of any provision shall not affect the validity or enforceability of the other provisions hereof.



14. Entire Agreement.

This Agreement constitutes the entire agreement between the parties hereto and supersedes all prior agreements, understandings and arrangements, oral or written, between the parties hereto with respect to the subject matter hereof including.

15. Registration Rights.

(a) If the Company at any time proposes to register any of its securities under the Securities Act of 1933, as from time to time in effect (together with the rules and regulations thereunder, all as from time to time in effect, the "Securities Act"), for its own account or for the account of any holder of its securities, on a form which would permit registration of Common Stock of the Company at the time held or obtainable upon the exercise of options, warrants or rights, or the conversion of convertible securities, at the time held by the Executive ("Registrable Securities"), for sale to the public under the Securities Act, the Company will each such time give notice to the Executive of its intention to do so. Such notice shall describe such securities and specify the form, manner and other relevant aspects of such proposed registration. The Executive may, by written response delivered to the Company within 15 days after the giving of any such notice, request that all or a specified part of the Registrable Securities be included in such registration. the Company will thereupon use its best efforts as part of its filing of such form to effect the registration under the Securities Act of all Registrable Securities which the Company has been so requested to register by the Executive, to the extent required to permit the disposition (in accordance with the intended methods thereof as aforesaid) of the Registrable Securities to be so registered.

(b) The Executive may, by notice to the Company specifying the intended method or methods of disposition, given at any time and from time to time after the Company has registered any shares of its Common Stock under the Securities Act, request that the Company effect the registration under the Securities Act of all or a specified part of the Registrable Securities; provided, however, that the Company shall not be required to effect a registration pursuant to this Section 15(b) unless such registration may be effected on a Form S-3 (or any successor or similar Form); and provided, further, that each registration pursuant to this Section 15(b) shall cover a number of Registrable Shares equal to not less than 2% of the aggregate number of shares of the Company Common Stock then outstanding. the Company will then use its best efforts to effect the registration as promptly as practicable under the Securities Act of the Registrable Securities which the Company has been requested to register by the Executive pursuant to the Section 15(b).

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(c) Notwithstanding the provisions of Section 15(b), in the event that Executive has requested pursuant to Section 15(b) that the Company effect a registration of securities, and (i) the CEO of the Company determines that it would be seriously detrimental to the Company to effect a registration pursuant to Section 15(b), or (ii) the CEO of the Company determines in good faith that (A) the Company is in possession of material, non-public information concerning an acquisition, merger, recapitalization, consolidation, reorganization or other material transaction by or of the Company or concerning pending or threatened litigation and (B) disclosure of such information would jeopardize any such transaction or litigation or otherwise materially harm the Company, then the Company shall promptly notify Executive of the occurrence of any of the events described in the foregoing clauses (i) or (ii). Upon the occurrence of any of the events described in clauses (i) or (ii) hereof, the Company shall be allowed to defer a registration of securities pursuant to Section 15(b) above, and if a registration statement had already been filed at such time, Executive shall not dispose of his Registrable Securities under such registration statement until it is so advised in writing by the Company that the registration of securities under 15(b) may be effected or resumed. Notwithstanding the foregoing, any

such deferment or prohibition on disposition shall not be in effect for more than 90 days in any 12 months period.

- (d) The Company shall not be obligated to effect any registration of Registrable Securities under Section 15(a) hereof incidental to the registration of any of its securities in connection with mergers, acquisitions, exchange offers, dividend reinvestment plans or stock option or other employee benefit plans.
- (e) The Company hereby agrees to pay, or cause to be paid, all legal, accounting, printing and other expenses (other than the fees and expenses of the Executive's own counsel and other than underwriting discounts and commissions attributable to the Registrable Securities) in connection with each registration of Registrable Securities pursuant to this Section 15.
- (f) In connection with each registration of Registrable Securities pursuant to this Section 15, the Company and the Executive will enter into such agreements, containing such terms and conditions, as are customary in connection with public offerings, such agreements to contain, without limitation, customary indemnification provisions, representations and warranties and opinions and other documents to be delivered in connection therewith, and to be, if requested, with underwriters.
- (g) The provisions of this Section 15 shall be subject to any agreement entered into by the Company, in good faith, with any underwriter of the Company's securities or any person or entity providing financing to the Company, in each case containing reasonable limitations on the Executive's rights and the Company's obligations hereunder.

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- (h) The provisions of this Section 15 shall survive the termination of the other provisions of this Agreement. The rights of the Executive under this Section 16 are assignable, in whole or in part, by the Executive to any person or other entity acquiring securities of the Company from the Executive.
- (i) Notwithstanding anything in the foregoing to the contrary, the Executive shall not demand a registration during the 180 days following an underwritten public offering of the Common Stock of the Company.
- (j) Without the prior written consent of the underwriters managing any public offering, for a period beginning ten days immediately preceding the effective date of any registration statement filed by the Company under the Securities Act of 1933, as amended, and ending on the earlier of (i) 180 days after the effective date of such registration statement and (ii) the end of the shortest period generally applicable to any "affiliate" (as defined in the Securities Act of 1933, as amended) of the Company who is a selling shareholder pursuant to such registration statement or who is otherwise subject to a lockup provision, the Executive (whether or not a selling shareholder pursuant to such registration statement) shall not sell or otherwise transfer any securities of the Company except pursuant to such registration statement.

IN WITNESS WHEREOF, the Company has caused this Agreement to be executed by its duly authorized officer and the Executive has executed this Agreement as of the day and year first above written.

ELECTRIC FUEL (E.F.L.) LTD.

By: \_\_\_\_\_

Name:  
Title:

STEVEN ESSES

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Exhibit A

This mutual release is executed and delivered by and between the undersigned employee of Arotech Corporation, a Delaware corporation (the "Company") and the undersigned's successors, assigns, executors, estates and personal representatives (collectively, the "Executive"), on the one hand, and the Company and its affiliates, agents, successors and assigns (collectively, the "Company"), on the other hand. For and in consideration of the Executive receiving the compensation referred to in Section 7 of the Employment Agreement effective as of January 1, 2005 and other good and valuable consideration, the adequacy and receipt of which are hereby acknowledged by the Executive and the Company, the Executive hereby remises, releases and forever discharges the Company, and the Company hereby remises, releases and forever discharges the Executive, of and from any and all manner of action and actions, cause and causes of actions, suits, debts, dues, sums of money, accounts, reckonings, bonds, bills, covenants, contracts, controversies, executions, claims and demands of any kind and nature whatsoever in law or in equity, known or unknown, against the other party which ever existed prior to the date hereof, or may ever have on and after the date hereof with respect to matters arising, and dealings with the other party occurring, prior to the date hereof; provided, however, that nothing contained herein shall be construed to release the Executive from any obligations to the Company pursuant to the Employment Agreement nor to release the Company from any of its obligations to the Executive pursuant to the Employment Agreement.

IN WITNESS WHEREOF, the Executive and the Company have each caused this Release to be executed as of \_\_\_\_\_.

ELECTRIC FUEL (E.F.L.) LTD.

By:

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Name:  
Title:

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STEVEN ESSES

## 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this 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
- (d) 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 fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of 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: May 16, 2005

/s/ Robert S. Ehrlich

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Robert S. Ehrlich, Chairman, President  
and CEO

(Principal Executive Officer)

A signed original of this written statement required by Section 302 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 302 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.

## 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this 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
- (d) 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 fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of 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: May 16, 2005

/s/ Avihai Shen

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

A signed original of this written statement required by Section 302 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 302 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.

WRITTEN STATEMENT

In connection with the Quarterly Report of Arotech Corporation (the "Company") on Form 10-Q for the quarterly period ended March 31, 2005 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: May 16, 2005

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.



WRITTEN STATEMENT

In connection with the Quarterly Report of Arotech Corporation (the "Company") on Form 10-Q for the quarterly period ended March 31, 2005 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: May 16, 2005

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.