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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2018.

Commission file number: 0-23336

AROTECH CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

95-4302784

(I.R.S. Employer
Identification No.)

1229 Oak Valley Drive, Ann Arbor, Michigan

(Address of principal executive offices)

48108

(Zip Code)

800 281-0356

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, 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 has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See definition of "large accelerated filer," "accelerated filer" "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer:

Accelerated filer:

Non-accelerated filer:

Smaller reporting company:

(Do not check if a smaller reporting company)

Emerging growth company:

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the issuer's common stock as of November 5, 2018 was 26,486,152.

SEC 1296 (09-18)

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PART I

ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS
(U.S. Dollars)

	September 30, 2018	December 31, 2017
	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 4,990,824	\$ 5,205,246
Restricted collateral deposits	191,364	283,508
Trade receivables	14,189,909	19,258,960
Unbilled receivables	19,549,492	16,094,515
Other accounts receivable and prepaid expenses	3,126,811	2,342,220
Inventories	9,749,759	8,654,878
Total current assets	51,798,159	51,839,327
LONG TERM ASSETS:		
Contractual and Israeli statutory severance pay fund	3,761,829	3,754,789
Other long term receivables	590,337	184,331
Property and equipment, net	9,150,586	9,276,088
Other intangible assets, net	4,313,179	5,205,605
Goodwill	46,138,036	46,138,036
Total long term assets	63,953,967	64,558,849
Total assets	\$ 115,752,126	\$ 116,398,176
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 5,889,008	\$ 5,560,196
Other accounts payable and accrued expenses	5,591,956	6,640,154
Current portion of long term debt	2,220,500	2,248,043
Short term bank credit	4,774,358	5,092,088
Deferred revenues	6,514,101	6,778,313
Total current liabilities	24,989,923	26,318,794
LONG TERM LIABILITIES:		
Contractual and accrued Israeli statutory severance pay	4,746,186	4,709,807
Long term portion of debt	6,908,172	8,570,524
Deferred income tax liability	6,107,265	5,600,721
Other long term liabilities	116,398	105,112
Total long-term liabilities	17,878,021	18,986,164
Total liabilities	42,867,944	45,304,958
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – \$0.01 par value each; Authorized: 50,000,000 shares as of September 30, 2018 and December 31, 2017; Issued and outstanding: 26,486,152 shares and 26,395,048 shares as of September 30, 2018 and December 31, 2017, respectively	264,862	263,951
Preferred shares – \$0.01 par value each; Authorized: 1,000,000 shares as of September 30, 2018 and December 31, 2017; No shares issued or outstanding as of September 30, 2018 and December 31, 2017	—	—
Additional paid-in capital	251,263,461	250,826,873
Accumulated deficit	(180,149,130)	(181,568,757)
Notes receivable from stockholders	(908,054)	(908,054)
Accumulated other comprehensive income	2,413,043	2,479,205
Total stockholders' equity	72,884,182	71,093,218
Total liabilities and stockholders' equity	\$ 115,752,126	\$ 116,398,176

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

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(UNAUDITED)
(U.S. Dollars, except share data)

	Nine months ended September 30,		Three months ended September 30,	
	2018	2017	2018	2017
Revenues	\$ 72,967,596	\$ 69,726,579	\$ 23,844,477	\$ 25,930,441
Cost of revenues	51,328,827	50,007,949	16,516,663	18,673,955
Research and development expenses	2,518,787	2,791,519	753,792	1,031,669
Selling and marketing expenses	5,647,284	5,674,653	1,837,823	1,707,209
General and administrative expenses	9,413,379	8,588,759	3,201,566	2,732,171
Amortization of intangible assets	1,298,573	1,728,956	391,831	509,303
Total operating costs and expenses	70,206,850	68,791,836	22,701,675	24,654,307
Operating income	2,760,746	934,743	1,142,802	1,276,134
Other income (expense), net	5,878	(13,498)	(1,521)	(23,758)
Financial expense, net	(696,232)	(749,967)	(173,345)	(200,923)
Total other expense	(690,354)	(763,465)	(174,866)	(224,681)
Income before income tax expense	2,070,392	171,278	967,936	1,051,453
Income tax expense	650,765	745,995	227,380	263,235
Net income (loss)	1,419,627	(574,717)	740,556	788,218
Other comprehensive income, net of income tax:				
Foreign currency translation adjustment	(66,162)	1,420,099	13,100	(166,075)
Comprehensive income	\$ 1,353,465	\$ 845,382	\$ 753,656	\$ 622,143
Income (loss) per share of common stock:				
Basic net income (loss) per share	\$ 0.05	\$ (0.02)	\$ 0.03	\$ 0.03
Diluted net income (loss) per share	\$ 0.05	\$ (0.02)	\$ 0.03	\$ 0.03
Weighted average number of shares used in computing basic net income (loss) per share	26,466,948	26,202,386	26,486,152	26,394,613
Weighted average number of shares used in computing diluted net income (loss) per share	26,466,948	26,202,386	26,486,152	26,394,613

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

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

	Nine months ended September 30,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 1,419,627	\$ (574,717)
<i>Adjustments required to reconcile net income (loss) to net cash provided by operating activities:</i>		
Depreciation	1,465,716	1,277,985
Amortization of intangible assets	1,298,573	1,728,956
Stock based compensation	491,654	309,053
Deferred tax provision	506,544	685,908
<i>Changes in operating assets and liabilities:</i>		
Trade receivables	4,992,521	3,416,571
Unbilled receivables	(3,454,977)	(4,008,309)
Other accounts receivable and prepaid expenses	(1,195,029)	(391,646)
Inventories	(1,116,401)	620,751
Severance pay, net	(12,886)	(1,981,943)
Trade payables	319,488	1,815,709
Other accounts payable and accrued expenses	(1,068,136)	(223,856)
Deferred revenues	(264,212)	(1,831,183)
<i>Net cash provided by operating activities</i>	<u>\$ 3,382,482</u>	<u>\$ 843,279</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	\$ (1,342,060)	\$ (3,733,323)
Additions to capitalized software	(406,147)	(131,169)
Decrease in restricted collateral deposits	—	(33,398)
<i>Net cash used in investing activities</i>	<u>\$ (1,748,207)</u>	<u>\$ (3,897,890)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long term debt	\$ —	\$ 2,150,000
Repayment of long term debt	(1,689,895)	(1,284,278)
Other financing activities	(54,155)	—
Change in short term bank credit	(317,730)	104,927
<i>Net cash (used in) provided by financing activities</i>	<u>\$ (2,061,780)</u>	<u>\$ 970,649</u>
DECREASE IN CASH, RESTRICTED CASH, AND CASH EQUIVALENTS	<u>\$ (427,505)</u>	<u>\$ (2,083,962)</u>
CASH DIFFERENCES DUE TO EXCHANGE RATE DIFFERENCES	\$ 120,939	\$ (712,004)
CASH, RESTRICTED CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD	<u>\$ 5,488,754</u>	<u>\$ 7,130,983</u>
CASH, RESTRICTED CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	<u>\$ 5,182,188</u>	<u>\$ 4,335,017</u>
SUPPLEMENTARY CASH FLOW INFORMATION:		
Interest paid during the period	\$ 658,134	\$ 531,210
Taxes paid on income during the period	\$ 79,983	\$ 152,444

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

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1: BASIS OF PRESENTATION

a. Company:

Arotech Corporation (“Arotech”) and its wholly-owned subsidiaries (the “Company”) provide defense and security products for the military, law enforcement, emergency services and homeland security markets, including multimedia interactive simulators/trainers, and lithium batteries and chargers. The Company operates primarily through its wholly-owned subsidiaries FAAC Incorporated, a Michigan corporation located in Ann Arbor, Michigan (Training and Simulation Division) with a location in Orlando, Florida; Epsilon-Electric Fuel Ltd. (“Epsilon-EFL”), an Israeli corporation located in Beit Shemesh, Israel (between Jerusalem and Tel-Aviv) and in Dimona, Israel (in Israel’s Negev desert area) (Power Systems Division); UEC Electronics, LLC (“UEC”), a South Carolina limited liability company located in Hanahan, South Carolina (Power Systems Division).

b. Basis of Presentation:

The Company prepared the accompanying unaudited condensed consolidated financial statements of Arotech Corporation and all wholly-owned, majority owned or otherwise controlled subsidiaries on the same basis as its annual audited financial statements. The Company condensed or omitted certain information and footnote disclosures normally included in its annual audited financial statements, which it prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP), 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. The Company’s quarterly financial statements should be read in conjunction with its Annual Report on Form 10-K for the year ended December 31, 2017. 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 September 30, 2018, its operating results for the nine- and three-month periods ended September 30, 2018 and 2017, and its cash flows for the nine-month periods ended September 30, 2018 and 2017.

The results of operations for the nine and three months ended September 30, 2018 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending December 31, 2018.

The condensed consolidated balance sheet at December 31, 2017 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 condensed 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, 2017.

c. Reclassification:

From time to time the Company may reclassify amounts from prior periods to conform to current year’s presentation.

d. Commitments and contingencies:

The Company is involved in litigation from time to time in the regular course of its business. There are no material legal proceedings pending or known by the Company to be contemplated to which the Company is a party or to which any of its property is subject. In addition, the Company believes that adequate provisions for resolution of all contingencies have been made for probable losses that are reasonably estimable. These contingencies are subject to uncertainties, and, as a result, the Company is unable to estimate the amount or range of loss, if any, in excess of amounts accrued. The Company does not believe that these contingencies will have a material adverse effect on the Company’s balance sheets, statements of operations and comprehensive income or statements of cash flows for the three and nine months ended September 30, 2018.

e. Goodwill and other long-lived assets:

Goodwill and indefinite-lived intangible assets are tested for impairment at least annually and between annual tests in certain circumstances, and written down when impaired. Goodwill is tested for impairment by comparing the fair value of the Company’s reporting units with the carrying value. The Training and Simulation and the Power Systems reporting units have goodwill.

As of its last annual impairment test at December 31, 2017, the Company determined that the goodwill for both reporting units was not impaired.

The Company has historically performed its annual goodwill impairment test as of December 31 each year. During the quarter ended September 30, 2018, the Company voluntarily changed its annual impairment assessment date from December 31 to October 1. The Company believes this change in measurement date, which represents a change in method of applying an accounting principle, is preferable under the circumstances as it better aligns with its forecasting and annual budgeting process timeline. The Company intends to utilize the same valuation approach and does not expect the change in valuation date to produce different impairment results. As the Company assesses qualitative factors that may give rise to triggering events quarterly, the Company does not consider the change in date of its annual impairment test material to its financial statements.

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Consistent with previous interim reporting periods, the Company monitors qualitative and quantitative factors, including internal projections, periodic forecasts, and actual results of the reporting unit. Based upon this interim review, the Company does not believe that goodwill or its indefinite-lived intangible assets related to either reporting unit is impaired.

f. New accounting pronouncements:

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. In addition, in July 2018, the FASB issued ASU No. 2018-10, *Codification Improvement to Topic 842*.

In July 2018, the FASB issued ASU No. 2018-11, *Targeted Improvements to Topic 842*. This amendment provides the Company with an additional and optional transition method to adopt the new leases standard. Under this new transition method, the Company can apply the new lease standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption and present the accounting on a prospective or go-forward basis instead of applying to the earliest comparative period presented in the financial statements. The standard will be effective for the Company beginning January 1, 2019.

The Company will elect to apply the new transition method upon adoption of the new standard. The Company will also elect the available practical expedients on adoption. In preparation for adoption of the standard, the Company is in the process of finalizing changes to systems, implementing internal controls and key processes to enable the preparation of financial information.

The new standard will have a material impact on the Company's consolidated balance sheets, but will not have a material impact on its consolidated income statements. The most significant impact will be the recognition of ROU assets and lease liabilities for operating leases and will result in additional ROU assets and lease liabilities for operating leases of approximately \$5.6 million and \$5.7 million, respectively, as of January 1, 2019.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES UPDATE

The Company's significant accounting policies are detailed in "Note 2: Significant Accounting Policies" of its Form 10-K for the year ended December 31, 2017. Significant changes to the Company's accounting policies as a result of changes in functional currency, the impact of changes to tax legislation, and adopting Accounting Standards Codification ("ASC") 606 are discussed below:

Functional Currency:

The United States dollar ("U.S. dollar") is the currency of the primary economic environment in which the Company's U.S. subsidiaries operate and the Company has adopted and is using the U.S. dollar as its functional currency. Transactions and balances originally denominated in U.S. dollars are presented at the original amounts. Accordingly, monetary accounts maintained in currencies other than dollars are re-measured into dollars, with resulting gains and losses reflected in the consolidated statements of operations and comprehensive income as financial income or expenses, as appropriate.

In the first quarter of 2018, the Company concluded that the functional currency for its Israeli subsidiary, Epsilor-EFL, changed from the New Israeli Shekel to the U.S. dollar. The primary reason for the change in functional currencies is due to a change in Epsilor-EFL operations whereby the majority of its contracts and material costs are anticipated to be sourced in U.S. dollars. The Company believes that the change in functional currency for this business was necessary as it reflects the primary economic environment in which Epsilor-EFL now operates.

The change in functional currency for Epsilor-EFL is accounted for prospectively from January 1, 2018, and prior year financial statements have not been restated for the change in functional currency. The financial statements of Epsilor-EFL are now reported in U.S. dollars. All balance sheet accounts were translated using the exchange rates in effect at the time of the change in functional currency. The statements of comprehensive income and cash flows are also reported in U.S. dollars.

Income Taxes:

The U.S. Tax Cuts and Jobs Act ("Tax Act") was enacted on December 22, 2017. The Tax Act makes broad complex changes to the U.S. tax code including, but not limited to, reducing the U.S. federal corporate tax rate from 35% to 21%, requiring companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, and creating new taxes on certain foreign sourced earnings and additional limitations on the deductibility of interest.

The SEC issued Staff Accounting Bulletin No. 118 (SAB 118) in December, 2017, to provide guidance on accounting for the effects of the Tax Act. SAB 118 provides for a measurement period of up to one year from the Tax Act enactment date for companies to complete their assessment of and accounting for those effects of the Tax Act. Under SAB 118, a company must first reflect the income tax effects of the Tax Act for which the accounting is complete in the period of the date of enactment. To the extent the accounting for other income tax effects is incomplete, but a reasonable estimate can be determined, companies must record a provisional estimate to be included in their financial statements. For any income tax effect for which a reasonable estimate cannot be determined, an entity must continue to apply ASC 740 based on the provisions of the tax laws in effect immediately prior to the Tax Act being enacted until such time as a reasonable estimate can be determined. The Company requires additional time to complete its analysis of the impacts of the Tax Act and therefore its accounting for the Tax Act is provisional but is a reasonable estimate based on available information. The Company will

complete its analysis and finalize its accounting for this provisional estimate during the one year measurement period as prescribed by SAB 118.

Revenue recognition:

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers, as a new Topic, ASC 606. The new revenue recognition standard relates to revenue from contracts with customers, which, along with amendments issued in 2016 and 2015, supersedes nearly all current U.S. GAAP guidance on this topic and eliminates industry-specific guidance.

The Company accounts for revenue in accordance with ASC 606, Revenue from Contracts with Customers, which the Company adopted on January 1, 2018, using the modified retrospective method. The Company evaluated the distinct performance obligations and the pattern of revenue recognition of its significant contracts upon adoption of the standard. Consequently, after its review of contracts in each revenue stream, the Company concluded that the impact of adopting the standard did not have an impact to its consolidated balance sheets, statements of operations, changes in stockholders’ equity, or cash flows.

During 2018 and 2017, the Company recognized revenues from (i) the sale and customization of interactive training systems (Training and Simulation Division); (ii) maintenance services in connection with such systems (Training and Simulation Division); (iii) the sale of batteries, chargers and adapters, and custom power solutions (Power Systems Division); and (iv) the sale of lifejacket lights (Power Systems Division).

The Company determines its revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations within the contract
- Determination of the transaction price
- Allocation of the transaction price to the performance obligations within the contract
- Recognition of revenue when, or as the performance obligation has been satisfied

Performance Obligations. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASC Topic 606. A contract’s transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. In assessing the recognition of revenue, the Company evaluates whether two or more contracts should be combined and accounted for as one contract and if the combined or single contract should be accounted for as multiple performance obligations which could change the amount of revenue and profit (loss) recorded in a period. The majority of the Company’s contracts with customers are accounted for as one performance obligation, as the majority of tasks and services is part of a single project or capability. As these contracts are typically a customized customer-specific solution, the Company uses the expected cost plus margin approach to estimate the standalone selling price of each performance obligation. For contracts with multiple performance obligations, the Company allocates the contract’s transaction price to each performance obligation using its best estimate of the standalone selling price of each distinct good or service in the contract.

The Company also offers maintenance and support agreements (“warranties”) for many of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the product was sold. The warranty revenue is recognized on a straight-line basis over the term of the maintenance and support services. The standalone selling price is determined based on the price charged when sold separately or upon renewal.

The Company’s performance obligations are satisfied over time as work progresses or at a point in time. Revenue from products and services transferred to customers over time accounted for 92% and 93% of its revenue for the nine-month periods ended September 30, 2018 and 2017, respectively. Substantially all of the Company’s revenue in the Training and Simulation Division and the U.S. Power Systems Division is recognized over time. Typically, revenue is recognized over time using an input measure (e.g., costs incurred to date relative to total estimated costs at completion) to measure progress. Contract costs include labor, material, and overhead.

On September 30, 2018, the Company had \$70.7 million of expected future revenue relating to performance obligations currently in progress, which it also refers to as total backlog. The Company expects to recognize approximately 29% percent of its backlog as revenue in 2018, and the remaining 71% percent by the end of 2019 and thereafter.

Contract Estimates. Accounting for long-term contracts and programs involves the use of various techniques to estimate total contract revenue and costs. For long-term contracts, the Company estimates the profit on a contract as the difference between the total estimated revenue and expected costs to complete a contract and recognize that profit over the life of the contract.

Contract estimates are based on various assumptions to project the outcome of future events that can exceed a year. These assumptions include labor productivity and availability; the complexity of the work to be performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer.

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As a significant change in one or more of these estimates could affect the profitability of its contracts, the Company reviews and updates its contract-related estimates quarterly. The Company recognizes adjustments in estimated profit on contracts under the cumulative catch-up method. Under this method, the impact of the adjustment on profit recorded to date is recognized in the period the adjustment is identified. Revenue and profit in future periods of contract performance is recognized using the adjusted estimate. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, the Company recognizes the total loss in the quarter it is identified.

The aggregate impact of adjustments in contract estimates to net income (loss) is presented below:

	Nine months ended September 30,			
	2018		2017	
	Training and Simulation Division	Power Systems Division	Training and Simulation Division	Power Systems Division
Net income (loss)	\$ 449,580	\$ 77,403	\$ 858,769	\$ 92,050

	Three months ended September 30,			
	2018		2017	
	Training and Simulation Division	Power Systems Division	Training and Simulation Division	Power Systems Division
Net income (loss)	\$ (139,016)	\$ 320,269	\$ 402,581	\$ (208,861)

Revenue by Category. As of September 30, 2018 and 2017 the Company's portfolio of products and services consisted of 525 and 500 active contracts, respectively.

Revenue by major product line was as follows:

	Nine months ended September 30,		Three months ended September 30,	
	2018	2017	2018	2017
Product Revenue				
Air Warfare Simulation	\$ 13,324,429	\$ 14,476,934	\$ 3,667,058	\$ 5,075,082
Vehicle Simulation	17,040,554	8,694,974	6,040,922	4,351,624
Use-of-Force	10,677,612	9,636,388	4,132,059	4,489,977
Service Revenue				
Warranty	2,533,558	2,331,673	825,863	680,284
Total Training and Simulation Division	\$ 43,576,153	\$ 35,139,969	\$ 14,665,902	\$ 14,596,967
Power Division				
Contract Manufacturing	\$ 10,130,597	\$ 9,565,368	\$ 3,100,586	\$ 3,114,482
Power Distribution and Generation	5,695,039	3,810,061	1,413,117	1,479,509
Batteries	9,767,890	16,134,215	3,118,375	4,944,867
Engineering Services and Other	3,797,917	5,076,966	1,546,497	1,794,616
Total Power Division	\$ 29,391,443	\$ 34,586,610	\$ 9,178,575	\$ 11,333,474

The table below details the percentage of total recognized revenue by type of arrangement for the nine and three months ended September 30, 2018 and 2017:

Type of Revenue	Nine months ended September 30,		Three months ended September 30,	
	2018	2017	2018	2017
Sale of products	95.0%	96.7%	94.5%	97.2%
Maintenance and support agreements	3.5%	3.3%	3.5%	2.6%
Long term research and development contracts	1.5%	—%	2.0%	0.2%
Total	100%	100%	100%	100%

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Revenue by contract type was as follows:

	Training and Simulation Division	Power Systems Division
<u>Nine months ended September 30, 2018</u>		
Fixed Price	\$ 35,975,495	\$ 26,807,005
Cost Reimbursement (Cost Plus)	4,120,987	1,822,659
Time and Materials	3,479,671	761,779
Total	<u>\$ 43,576,153</u>	<u>\$ 29,391,443</u>
<u>Nine months ended September 30, 2017</u>		
Fixed Price	\$ 28,849,966	\$ 28,830,143
Cost Reimbursement (Cost Plus)	4,610,512	4,203,220
Time and Materials	1,679,491	1,553,247
Total	<u>\$ 35,139,969</u>	<u>\$ 34,586,610</u>
<u>Three months ended September 30, 2018</u>		
Fixed Price	\$ 11,948,500	\$ 8,372,521
Cost Reimbursement (Cost Plus)	1,511,711	567,767
Time and Materials	1,205,691	238,287
Total	<u>\$ 14,665,902</u>	<u>\$ 9,178,575</u>
<u>Three months ended September 30, 2017</u>		
Fixed Price	\$ 12,657,859	\$ 9,250,841
Cost Reimbursement (Cost Plus)	1,524,987	1,714,584
Time and Materials	414,121	368,049
Total	<u>\$ 14,596,967</u>	<u>\$ 11,333,474</u>

Each of these contract types presents advantages and disadvantages. Typically, the Company assumes more risk with fixed-price contracts. However, these types of contracts offer additional profits when the Company completes the work for less than originally estimated. Cost-reimbursement contracts generally subject the Company to lower risk. Accordingly, the associated base fees are usually lower than fees earned on fixed-price contracts. Under time and materials contracts, the Company's profit may fluctuate if actual labor-hour costs vary significantly from the negotiated rates.

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Revenue by customer was as follows:

	Training and Simulation Division	Power Systems Division
<u>Nine months ended September 30, 2018</u>		
U.S. Government		
Department of Defense (DoD)	\$ 12,399,861	\$ 2,115,108
Non-DoD	7,655,130	—
Foreign Military Sales (FMS)	2,055,333	—
Total U.S. Government	<u>\$ 22,110,324</u>	<u>\$ 2,115,108</u>
U.S. Commercial	\$ 16,546,210	\$ 16,159,067
Non-U.S. Government	1,786,538	2,003,417
Non-U.S. Commercial	3,133,081	9,113,851
Total Revenue	<u>\$ 43,576,153</u>	<u>\$ 29,391,443</u>
<u>Nine months ended September 30, 2017</u>		
U.S. Government		
Department of Defense (DoD)	\$ 7,698,425	\$ 7,166,810
Non-DoD	8,604,167	—
Foreign Military Sales (FMS)	1,128,897	—
Total U.S. Government	<u>17,431,489</u>	<u>7,166,810</u>
U.S. Commercial	\$ 13,697,477	\$ 10,603,502
Non-U.S. Government	2,815,271	9,014,963
Non-U.S. Commercial	1,195,732	7,801,335
Total Revenue	<u>\$ 35,139,969</u>	<u>\$ 34,586,610</u>
<u>Three months ended September 30, 2018</u>		
U.S. Government		
Department of Defense (DoD)	\$ 4,753,006	\$ 772,751
Non-DoD	3,272,251	—
Foreign Military Sales (FMS)	341,933	—
Total U.S. Government	<u>8,367,190</u>	<u>772,751</u>
U.S. Commercial	\$ 4,744,148	\$ 4,669,493
Non-U.S. Government	394,091	180,253
Non-U.S. Commercial	1,160,473	3,556,078
Total Revenue	<u>\$ 14,665,902</u>	<u>\$ 9,178,575</u>
<u>Three months ended September 30, 2017</u>		
U.S. Government		
Department of Defense (DoD)	\$ 3,226,920	\$ 2,715,675
Non-DoD	3,162,425	—
Foreign Military Sales (FMS)	721,353	—
Total U.S. Government	<u>7,110,698</u>	<u>2,715,675</u>
U.S. Commercial	\$ 5,765,592	\$ 3,204,902
Non-U.S. Government	1,496,856	3,392,865
Non-U.S. Commercial	223,821	2,020,032
Total Revenue	<u>\$ 14,596,967</u>	<u>\$ 11,333,474</u>

Contract Balances. The timing of revenue recognition, billings and cash collections results in billed accounts receivable, unbilled receivables (contract assets), and customer advances and deposits (contract liabilities) on the Consolidated Balance Sheet. The majority of the Company's contract amounts are billed as work progresses in accordance with agreed-upon contractual terms, either at periodic

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intervals (e.g., biweekly or monthly) or upon achievement of contractual milestones. Billing sometimes occurs subsequent to revenue recognition, resulting in contract assets. However, the Company sometimes receives advances or deposits from its customers, particularly on its international contracts, before revenue is recognized, resulting in contract liabilities. These assets and liabilities are reported on the Consolidated Balance Sheet on a contract-by-contract basis at the end of each reporting period.

	September 30, 2018		December 31, 2017	
	Training and Simulation Division	Power Systems Division	Training and Simulation Division	Power Systems Division
Unbilled Receivables – Current	\$ 9,681,738	\$ 9,867,754	\$ 7,263,461	\$ 8,831,055
Deferred Revenues – Current	(6,061,829)	(452,272)	(5,860,345)	(917,968)
Net Contract Assets and Liabilities:	\$ 3,619,909	\$ 9,415,482	\$ 1,403,116	\$ 7,913,087

The \$3.7 million increase in the Company's net contract assets (liabilities) from December 31, 2017 to September 30, 2018 was due to the timing of milestone payments on certain US Government and commercial contracts.

During the nine months ended September 30, 2018 and 2017, the Company recognized \$5.2 million and \$4.8 million in revenue related to the Company's contract liabilities at December 31, 2017 and 2016, respectively.

The Company did not record any provisions for impairment of its unbilled receivables during the nine months ended September 30, 2018 or 2017, respectively.

Trade Receivables

Trade receivables include amounts billed and currently due from customers. The amounts are recorded at net estimated realizable value. The value of the Company's trade receivables when appropriate includes an allowance for estimated uncollectible amounts. The Company calculates an allowance based on its history of write-offs, the assessment of customer creditworthiness, and the age of the outstanding receivables.

As of September 30, 2018 and December 31, 2017, the Company's trade receivables recorded in the consolidated balance sheets were \$14.2 million and \$19.3 million, respectively. The Company has not recorded any provisions for doubtful accounts and no reserves have been established at September 30, 2018 or December 31, 2017, respectively. The Company believes its exposure to concentrations of credit risk is limited due to the nature of its operations, where a significant number of its contracts are typically a customized customer specific solution.

Contract Costs

Certain eligible costs, typically incurred during the initial phases of the Company's service contracts, are capitalized when the costs related directly to the contract, are expected to be recovered, and generate or enhance resources to be used in satisfying the performance obligation. These costs primarily consist of production design. If the carrying amount is not recoverable, an impairment loss is recognized.

Practical Expedients and Exemptions

The Company has elected the following practical expedients and exemptions as allowed under the new revenue guidance:

Sales Commissions

The Company has elected to expense its sales commissions when incurred because the amortization period is less than one year. These costs are recorded within selling and marketing expenses.

Financing

The Company has elected to not adjust the consideration for the effects of a significant financing component as the term of the majority of contracts is twelve months or less.

Sales Tax

The Company acts as an agent in the collection and remittance of sales taxes. Historically, the Company has excluded these amounts from the calculation of revenue. These taxes will continue to be excluded from the transaction price.

Shipping and Handling Costs

The Company has elected to account for shipping and handling activities that are incurred after the customer obtained control of the product as fulfillment costs rather than a separate service provided to the customer for which consideration would need to be allocated.

The Company will continue to account for shipping and handling as fulfillment costs when these costs are incurred prior to the customer obtaining control.

NOTE 3: INVENTORIES

Inventories are stated at the lower of cost or net realizable value. Cost is determined by the first in, first out (“FIFO”) method. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume and based on these evaluations, provisions are made in each period to write down inventory to its net realizable value. For the nine months ended September 30, 2018 and 2017, the Company wrote off approximately \$558,000 and \$26,000, respectively, of obsolete inventory, which has been included in the cost of revenues.

Inventories by component are as follows:

	September 30, 2018	December 31, 2017
Raw and packaging materials	\$ 7,212,539	\$ 6,843,479
Work in progress	2,157,068	718,085
Finished products	380,152	1,093,314
Total:	<u>\$ 9,749,759</u>	<u>\$ 8,654,878</u>

NOTE 4: SEGMENT INFORMATION

a. The Company and its subsidiaries operate in two business segments. The two segments are also treated by the Company as reporting units for goodwill impairment evaluation purposes. The goodwill amounts associated with the Training and Simulation Division and the Power Systems Division were determined and valued when the specific businesses were purchased. The Company and its subsidiaries operate in two continuing business segments and follow the requirements of FASB ASC 280-10.

The Company’s reportable 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 reportable segments are the same as those used by the Company in the preparation of its annual financial statements. The Company evaluates performance based on 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.

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b. The following is information about reported segment revenues, income (losses) from operations, and total assets as of September 30, 2018 and 2017:

	Training and Simulation Division	Power Systems Division	Corporate Expenses	Total Company
<u>Nine months ended September 30, 2018</u>				
Revenues from outside customers	\$ 43,576,153	\$ 29,391,443	\$ —	\$ 72,967,596
Depreciation and amortization(1)	(605,195)	(2,159,094)	—	(2,764,289)
Direct expenses(2)	(34,347,504)	(30,102,162)	(2,987,017)	(67,436,683)
Segment operating income (loss)	\$ 8,623,454	\$ (2,869,813)	\$ (2,987,017)	\$ 2,766,624
Financial expense	(182,524)	10,148	(523,856)	(696,232)
Income tax expense	(144,221)	—	(506,544)	(650,765)
Net income (loss)	\$ 8,296,709	\$ (2,859,665)	\$ (4,017,417)	\$ 1,419,627
Segment assets(3)	\$ 54,996,173	\$ 57,639,253	\$ 3,116,700	\$ 115,752,126
Additions to long-lived assets	\$ 965,651	\$ 782,556	\$ —	\$ 1,748,207
<u>Nine months ended September 30, 2017</u>				
Revenues from outside customers	\$ 35,139,969	\$ 34,586,610	\$ —	\$ 69,726,579
Depreciation and amortization(1)	(772,736)	(2,230,750)	(3,455)	(3,006,941)
Direct expenses(2)	(29,723,546)	(33,425,392)	(2,649,455)	(65,798,393)
Segment operating income (loss)	\$ 4,643,687	\$ (1,069,532)	\$ (2,652,910)	\$ 921,245
Financial expense	(77,975)	(170,381)	(501,611)	(749,967)
Income tax benefit (expense)	(105,000)	44,913	(685,908)	(745,995)
Net income (loss)	\$ 4,460,712	\$ (1,195,000)	\$ (3,840,429)	\$ (574,717)
Segment assets(3)	\$ 48,550,296	\$ 57,675,628	\$ 3,314,767	\$ 109,540,691
Additions to long-lived assets	\$ 2,454,099	\$ 1,410,393	\$ —	\$ 3,864,492
<u>Three months ended September 30, 2018</u>				
Revenues from outside customers	\$ 14,665,902	\$ 9,178,575	\$ —	\$ 23,844,477
Depreciation and amortization(1)	(208,055)	(688,935)	—	(896,990)
Direct expenses(2)	(11,509,826)	(9,173,877)	(1,122,503)	(21,806,206)
Segment operating income (loss)	\$ 2,948,021	\$ (684,237)	\$ (1,122,503)	\$ 1,141,281
Financial expense	(43,545)	13,540	(143,340)	(173,345)
Income tax expense	(82,670)	—	(144,710)	(227,380)
Net income (loss)	\$ 2,821,806	\$ (670,697)	\$ (1,410,553)	\$ 740,556
<u>Three months ended September 30, 2017</u>				
Revenues from outside customers	\$ 14,596,967	\$ 11,333,474	\$ —	\$ 25,930,441
Depreciation, amortization and impairment expenses(1)	(224,611)	(698,939)	(1,183)	(924,733)
Direct expenses(2)	(11,672,943)	(11,269,961)	(810,428)	(23,753,332)
Segment operating income (loss)	\$ 2,699,413	\$ (635,429)	\$ (811,611)	\$ 1,252,376
Financial expense	(40,706)	7,367	(167,584)	(200,923)
Income tax expense	(35,000)	401	(228,636)	(263,235)
Net income (loss)	\$ 2,623,707	\$ (627,658)	\$ (1,207,831)	\$ 788,218

- (1) Includes depreciation of property and equipment and amortization expenses of intangible assets.
- (2) Including, *inter alia*, sales and marketing, general and administrative.
- (3) Out of those amounts, goodwill in the Company's Training and Simulation Division and Power Systems Division totaled \$24,435,641 and \$21,702,395, respectively, as of September 30, 2018 and \$24,435,641 and \$21,586,500, respectively, as of September 30, 2017.

NOTE 5: FAIR VALUE MEASUREMENT

The carrying value of short term assets and liabilities in the accompanying condensed consolidated balance sheets for cash and cash equivalents, restricted collateral deposits, trade receivables, unbilled receivables, inventories, prepaid and other assets, trade payables, accrued expenses, deferred revenues and other liabilities as of September 30, 2018 and December 31, 2017, approximate fair value because of the short maturity of these instruments. The carrying amounts of long term debt approximates the estimated fair values at September 30, 2018, based upon the Company's ability to acquire similar debt at similar maturities.

NOTE 6: BANK FINANCING

The Company maintains credit facilities with JPMorgan Chase Bank, N.A. ("Chase"), whereby Chase provides (i) a \$15,000,000 revolving credit facility ("Revolver"), (ii) a \$10,000,000 Term Loan ("Term Loan A"), (iii) a \$1,730,895 Mortgage Loan ("Term Loan B") and (iv) a \$1,358,000 Mortgage Loan ("Term Loan C"); collectively referred to as the "Credit Facilities."

The maturity of the Revolver is March 11, 2021. The Revolver maintains an interest rate on a scale ranging from LIBOR plus 1.75% up to LIBOR plus 3.00%. The effective interest rate for the revolver at September 30, 2018 was 5.25%. The balance at September 30, 2018 and December 31, 2017 was \$4.8 million and \$5.1 million, respectively.

The maturity of the Term Loan A is March 11, 2021. Term Loan A maintains an interest rate on a scale ranging from LIBOR plus 2.0% up to LIBOR plus 3.25%. The repayment of Term Loan A consists of 60 consecutive monthly payments of principal plus accrued interest based on annual principal reductions of 10% during the first year, 20% during the second through fourth years, and 30% during the fifth year. The effective interest rate for the Term Loan at September 30, 2018 was 5.50%. The balance at September 30, 2018 and December 31, 2017 was \$6.2 million and \$7.7 million, respectively.

During the quarter ended June 30, 2017, the Company purchased land and a building, previously leased by its Training and Simulation Division, in Ann Arbor, Michigan. As a result, the Company now maintains two Mortgage Loans ("Term Loans B and C"). The maturities of Term Loans B and C are June 1, 2024 and maintain an interest rate on a scale identical to Term Loan A. The monthly payments on Term Loan B and Term Loan C are \$7,212 and \$5,660, respectively, in principal plus accrued interest, with balloon payments due on the maturity date. The effective interest rate for the Mortgage Loans at September 30, 2018 was 5.50%. The balance of both loans at September 30, 2018 and December 31, 2017 was \$2.9 million and \$3.1 million, respectively.

The Credit Facilities maintain certain reporting requirements, conditions precedent, affirmative covenants and financial covenants. The Company is required to maintain certain financial covenants that include a Maximum Debt to EBITDA ratio of 3.00 to 1.00 and a Minimum Fixed Charge Coverage Ratio of 1.20 to 1.00. The Company was in compliance with its covenants at September 30, 2018.

The Credit Facilities are secured by the Company's assets and the assets of the Company's domestic subsidiaries.

NOTE 7: SUBSEQUENT EVENT

On October 3, 2018, the Company's U.S. Power Systems Division subsidiary was informed by its customer, Science Applications International Corporation ("SAIC"), that the United States Marines Corps ("USMC") had discontinued its efforts to upgrade the Assault Amphibious Vehicle ("AAV") fleet that was undergoing survivability and electrical upgrades under a prime contract with SAIC. As a result of this termination for the USMC's convenience, the Company will be presenting its unreimbursed costs related to this program for reimbursement by SAIC and the USMC. The amounts of and time frame for resolution have not yet been determined.

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” in our Annual Report on Form 10-K and in our other filings with the Securities and Exchange Commission.

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

We are a defense and security company engaged in two business areas: interactive simulation, and batteries and charging systems.

➤ We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for engineering, use-of-force training and operator training of military, law enforcement, security, emergency services and other personnel through our **Training and Simulation Division**.

➤ We provide advanced battery solutions, innovative energy management and power distribution technologies and world-class product design and manufacturing services for the aerospace, defense, law enforcement and homeland security markets, and we manufacture and sell primary rechargeable batteries, for defense and security products and medical and industrial applications through our **Power Systems Division**.

Overview of Operating Performance and Backlog

Overall, our pre-tax profit for the nine months ended September 30, 2018 was \$2.1 million on revenues of \$73.0 million, compared to pre-tax income of \$171,000 on revenues of \$69.7 million during the nine months ended September 30, 2017. Our overall backlog at the end of the third quarter of 2018 totaled \$70.7 million, compared to \$69.5 million at the end of 2017.

In our Training and Simulation Division, revenues for the nine months ended September 30, 2018 were \$43.6 million, compared to \$35.1 million during the nine months ended September 30, 2017. As of September 30, 2018, our backlog for our Training and Simulation Division totaled \$51.3 million, compared to \$41.5 million at the end of 2017.

In our Power Systems Division, revenues for the nine months ended September 30, 2018 were \$29.4 million, compared to \$34.6 million during the nine months ended September 30, 2017. As of September 30, 2018, our backlog for our Power Systems Division totaled \$19.4 million, compared to \$28.0 million at the end of 2017.

The table below details the percentage of total recognized revenue by type of arrangement for the nine and three months ended September 30, 2018 and 2017:

Type of Revenue	Nine months ended September 30,		Three months ended September 30,	
	2018	2017	2018	2017
Sale of products	95.0%	96.7%	94.5%	97.2%
Maintenance and support agreements	3.5%	3.3%	3.5%	2.6%
Long term research and development contracts	1.5%	—%	2.0%	0.2%
Total	100%	100%	100%	100%

Recent Developments

On October 3, 2018, our U.S. Power Systems Division subsidiary was informed by its customer, Science Applications International Corporation (“SAIC”), that the United States Marines Corps (“Marines”) had discontinued its efforts to upgrade the Assault Amphibious Vehicle program (“AAV”) fleet that was undergoing survivability and electrical upgrades under a prime contract with SAIC. As a result of this termination for the Marine’s convenience, we will be presenting its unreimbursed costs incurred related to this program for reimbursement by SAIC and the Marines. The amounts and time frame for resolution have not yet been determined.

Critical Accounting Policies

Please refer to our Form 10-K for the year ended December 31, 2017, for a discussion on our critical accounting policies. There have been no changes to our critical accounting policies except for the matters described below.

Goodwill and Indefinite-Lived Intangibles

We have historically performed our annual goodwill impairment test as of December 31 each year. During the quarter ended September 30, 2018, we voluntarily changed our annual impairment assessment date from December 31 to October 1. We believe this change in measurement date, which represents a change in method of applying an accounting principle, is preferable under the circumstances as it better aligns with our forecasting and annual budgeting process timeline. We intend to utilize the same valuation approach and do not expect the change in valuation date to produce different impairment results. As we assesses qualitative factors that may give rise to triggering events quarterly, we do not consider the change in date of our annual impairment test material to our financial statements.

Functional Currency

The United States dollar ("U.S. dollar") is the currency of the primary economic environment in which our U.S. subsidiaries operate and we have adopted and are using the U.S. dollar as our functional currency. Transactions and balances originally denominated in U.S. dollars are presented at the original amounts. Accordingly, monetary accounts maintained in currencies other than dollars are re-measured into dollars, with resulting gains and losses reflected in our consolidated statements of operations and comprehensive income as financial income or expenses, as appropriate.

In the first quarter of 2018, we concluded that the functional currency for our Israeli subsidiary, Epsilon-EFL, had changed from the New Israeli Shekel ("NIS") to the U.S. dollar. The primary reason for the change in functional currencies is due to a change in our operations whereby the majority of our contracts and our material costs is now anticipated to be sourced in U.S. dollars. We believe that the change in functional currency for this business was necessary as it reflects the primary economic environment in which Epsilon-EFL operates.

The financial statements of Epsilon-EFL are reported in U.S. dollars. All balance sheet accounts were translated using the exchange rates in effect at the time of the change in functional currency. Certain of Epsilon-EFL's subsidiaries continue to operate under the NIS functional currency. Correspondingly, translation gains and losses are reported in our statement of operations and comprehensive income and cash flows. The statements of operations and comprehensive income and cash flows are also reported in U.S. dollars.

Results of Operations

Three months ended September 30, 2018 compared to the three months ended September 30, 2017

Revenues. Revenues for the three months ended September 30, 2018 totaled \$23.8 million, compared to \$25.9 million in the comparable period in 2017, a decrease of \$2.1 million, or 8%. In the third quarter of 2018, revenues were \$14.7 million for the Training and Simulation Division as compared to \$14.6 million in the third quarter of 2017, an increase of \$68,000, or less than 1%; offset by a decrease in revenues in the Power Systems Division of \$2.2 million, or 19%, from \$11.3 million in the third quarter of 2017 to \$9.2 million in the third quarter of 2018, due primarily to a reduction in manufacturing of certain batteries in our Israeli operations and a decrease in revenues in our U.S. subsidiary related to delays on key customer programs. In addition, in late August, the government issued a stop work order on the AAV program, which ultimately led to the termination for the government's convenience of the AAV program on October 3, 2018.

Cost of revenues. Cost of revenues totaled \$16.5 million during the third quarter of 2018 as compared to \$18.7 million in the third quarter of 2017, a decrease of \$2.2 million, or 11.6%, due primarily to lower sales in our Power Systems Division. Cost of revenues was \$8.7 million for the Training and Simulation Division as compared to \$8.8 million in the third quarter of 2017, a decrease of \$99,000, or 1.1%; and \$7.8 million for the Power Systems Division as compared to \$9.9 million in the third quarter of 2017, a decrease of \$2.1 million, or 21%, due primarily to lower sales and program overruns as well as delays in certain programs.

Research and development expenses. Research and development expenses totaled \$754,000 during the third quarter of 2018 as compared to \$1.0 million for the third quarter of 2017, a decrease of \$278,000, or 26.9% which was due to the timing of research and development projects.

Selling and marketing expenses. Selling and marketing expenses for the third quarter of 2018 were \$1.8 million, compared to \$1.7 million in the third quarter of 2017, an increase of \$131,000, or 7.7%, due to primarily increased marketing efforts in our Training and Simulation Division.

General and administrative expenses. General and administrative expenses for the third quarter of 2018 were \$3.2 million, compared to \$2.7 million in the third quarter of 2017, an increase of \$469,000, or 17.2%, due primarily to increased investment in the Israeli operations, non-income based taxes, and a temporary increase in professional service fees.

Amortization of intangible assets. Amortization of intangible assets totaled \$392,000 in the third quarter of 2018, compared to \$509,000 in the third quarter of 2017, a decrease of \$117,000, or 23.1%, due primarily to higher amortization expense recognized in 2017 pertaining to shorter-lived intangible assets.

Other income (expense), net. Other expense in the third quarter of 2018 was \$2,000, compared to other expense of \$24,000 in the third quarter of 2017, a decrease of \$22,000.

Financial expense, net. Financial expense totaled \$173,000 in the third quarter of 2018, compared to financial expense of \$201,000 in the third quarter of 2017, a decrease of \$28,000, or 13.7%, due primarily to less long term debt outstanding in the third quarter of 2018 as a result of scheduled debt payments made during the preceding twelve months.

Income taxes. We recorded \$227,000 in tax expense in the third quarter of 2018, compared to \$263,000 in tax expense in the third quarter of 2017, a decrease of \$36,000, or 13.6%, due primarily to the reduction of the federal corporate income tax rate associated with the U.S. Tax Cuts and Jobs Act. This expense includes “naked” credits (“naked” credits occur when deferred tax liabilities that are created by indefinite-lived assets such as goodwill cannot be used as a source of taxable income to support the realization of deferred tax assets). This amount includes the required adjustment of taxes due to the deduction of goodwill “naked” credits for U.S. federal taxes, which totaled \$145,000 and \$228,000 in non-cash expenses in the third quarter of 2018 and 2017, respectively.

Net income (loss). Due to the factors cited above, we went from income of \$788,000 in the third quarter of 2017 to income of \$741,000 in the third quarter of 2018, a decrease of \$47,000.

Nine months ended September 30, 2018 compared to the nine months ended September 30, 2017

Revenues. Revenues for the nine months ended September 30, 2018 totaled \$73.0 million, compared to \$69.7 million in the comparable period in 2017, an increase of \$3.2 million, or 4.6%. In the first nine months of 2018, revenues were \$43.6 million for the Training and Simulation Division, compared to \$35.1 million in the first nine months of 2017, an increase of \$8.5 million, or 24.0% due primarily to improved performance in all major product categories; and \$29.4 million for the Power Systems Division, compared to \$34.6 million in the first nine months of 2017, a decrease of \$5.2 million, or 15.0%, due primarily to a reduction in manufacturing of certain batteries in our Israeli operations and a decrease in revenues in our U.S. subsidiary related to delays on key customer programs. In addition, in late August, the government issued a stop work order on the AAV program, which ultimately led to the termination for the government’s convenience of the AAV program on October 3, 2018.

Cost of revenues. Cost of revenues totaled \$51.3 million during the first nine months of 2018, compared to \$50.0 million in the first nine months of 2017, an increase of \$1.3 million or 2.6%, due primarily to an increase in revenues. Cost of revenues was \$25.5 million for the Training and Simulation Division, compared to \$20.2 million in the first nine months of 2017, an increase of \$5.3 million, or 26.5%, due primarily to higher costs associated with higher sales in all of our major product lines; and \$25.8 million for the Power Systems Division, compared to \$29.8 million in the first nine months of 2017, a decrease of \$4.0 million, or 13.5%, due primarily to a reduction in manufacturing of certain batteries in our Israeli operations.

Research and development expenses. Research and development expenses totaled \$2.5 million during the first nine months of 2018, compared to \$2.8 million for the first nine months of 2017 which was due to the timing of research and development projects.

Selling and marketing expenses. Selling and marketing expenses for the first nine months of 2018 were \$5.6 million, compared to \$5.7 million in the first nine months of 2017, a decrease of \$27,000.

General and administrative expenses. General and administrative expenses for the first nine months of 2018 were \$9.4 million, compared to \$8.6 million in the first nine months of 2017, an increase of \$825,000, or 9.6%, due primarily to increased investment in the Israeli operations, non-income based taxes, and a temporary increase in professional service fees.

Amortization of intangible assets. Amortization of intangible assets totaled \$1.3 million in the first nine months of 2018, compared to \$1.7 million in the first nine months of 2017, a decrease of \$430,000, or 24.9%, due primarily to higher amortization expense recognized in 2017 pertaining to shorter lived intangible assets.

Other income, net. Other income in the first nine months of 2018 was \$6,000 compared to other expense of \$13,000 in the first nine months of 2017, an increase of \$19,000.

Financial expense, net. Financial expense totaled \$696,000 in the first nine months of 2018, compared to financial expense of \$750,000 in the first nine months of 2017, a decrease of \$54,000, or 7.2%, primarily due to a net decrease in foreign exchange losses offset by an increase in interest expense related to Term Loan C, due to the inception of a new mortgage in June 2017.

Income taxes. We recorded \$651,000 in tax expense in the first nine months of 2018, compared to \$746,000 in tax expense in the first nine months of 2017, a decrease of \$95,000, or 12.8%. This expense includes “naked” credits (“naked” credits occur when deferred tax liabilities that are created by indefinite-lived assets such as goodwill cannot be used as a source of taxable income to support the realization of deferred tax assets). This amount includes the required adjustment of taxes due to the deduction of goodwill “naked” credits for U.S. federal taxes, which totaled \$507,000 and \$686,000 in non-cash expenses in the first nine months of 2018 and 2017, respectively.

Net income (loss). Due to the factors cited above, we went from a loss of (\$574,000) in the first nine months of 2017 to income of \$1.4 million in the first nine months of 2018, an increase of \$2.0 million.

Liquidity and Capital Resources

As of September 30, 2018, we had \$5.0 million in cash and \$191,000 in restricted collateral deposits, as compared to December 31, 2017, when we had \$5.2 million in cash and \$284,000 in restricted collateral deposits. We also had \$7.8 million in available, unused bank lines of credit with our main bank as of September 30, 2018, under a \$15.0 million credit facility.

We maintain credit facilities with JPMorgan Chase Bank, N.A. (“Chase”), whereby Chase provides (i) a \$15,000,000 revolving credit facility (“Revolver”), (ii) a \$10,000,000 Term Loan (“Term Loan A”), (iii) a \$1,730,895 Mortgage Loan (“Term Loan B”) and (iv) a \$1,358,000 Mortgage Loan (“Term Loan C”); collectively referred to as the “Credit Facilities.”

The maturity of the Revolver is March 11, 2021. The Revolver maintains an interest rate on a scale ranging from LIBOR plus 1.75% up to LIBOR plus 3.00%. The effective interest rate for the revolver at September 30, 2018 was 5.25%.

The maturity of Term Loan A is March 11, 2021. This Term Loan maintains an interest rate on a scale ranging from LIBOR plus 2.0% up to LIBOR plus 3.25%. The repayment of this Term Loan consists of 60 consecutive monthly payments of principal plus accrued interest based on annual principal reductions of 10% during the first year, 20% during the second through fourth years, and 30% during the fifth year. The effective interest rate for this Term Loan at September 30, 2018 was 5.50%.

We have two Mortgage Loans (Term Loans B and C). The maturities of the Mortgage Loans are June 1, 2024 and maintain an interest rate on a scale identical to the Term Loan. The monthly payments on the Mortgage Loans are \$12,872 in principal plus accrued interest, with balloon payments due at the maturity date. The effective interest rate for the Mortgage Loans at September 30, 2018 was 5.50%.

The Credit Facilities maintain certain reporting requirements, conditions precedent, affirmative covenants and financial covenants. We are required to maintain certain financial covenants that include a Maximum Debt to EBITDA ratio of 3.00 to 1.00 and a Minimum Fixed Charge Coverage Ratio of 1.20 to 1.00. We were in compliance with our covenants at September 30, 2018.

The Credit Facilities are secured by our assets and the assets of our domestic subsidiaries.

We used available funds in the nine months ended September 30, 2018 primarily for working capital needs and investment in fixed assets. Our net fixed assets amounted to \$9.2 million at quarter end.

Net cash provided by operating activities for the nine months ended September 30, 2018 was \$3.4 million. Net cash provided by operating activities for the nine months ended September 30, 2017 was \$843,000, representing a net change year over year of \$2.5 million. The increase in cash provided by operations is primarily attributable to improved operating results of \$1.8 million, a reduction in severance paid to a former executive of \$1.9 million, offset by an increased investment in working capital of \$1.2 million.

Net cash used in investing activities for the nine months ended September 30, 2018 was \$1.7 million. Net cash used in investing activities for the nine months ended September 30, 2017 was \$3.9 million, representing a year over year change of \$2.2 million. This difference was due primarily to the purchase of land and building of \$2.1 million in the second quarter of 2017.

Net cash provided by (used in) financing activities for the nine months ended September 30, 2018 and 2017 was (\$2.1) million and \$971,000, respectively, representing a decrease of \$3.0 million. In 2017, we obtained financing of \$2.2 million related to the purchase of land and buildings, increased our short-term borrowing on our line of credit by \$100,000; offset by payments on our term loans of \$1.3 million. In 2018, we made payments on our term loans of \$1.7 million and decreased our short-term borrowing on our line of credit by \$300,000.

As of September 30, 2018, we had approximately \$4.8 million in short-term bank debt under our credit facility and \$9.1 million in long-term loans outstanding. This is in comparison to December 31, 2017, when we had \$5.1 million in short-term bank debt under our credit facility and \$10.8 million in long-term debt outstanding.

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

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

We consider the United States dollar (U.S. dollar) to be the currency of the primary economic environment in which our U.S. and Israeli subsidiaries operate and have adopted the U.S. dollar as the functional currency for these businesses. The majority of financial transactions of our Israel-based subsidiary, Epsilon-EFL (“Epsilon”), are in U.S. dollars. However, since a portion of our labor and overhead costs in our Israeli businesses are denominated in New Israeli Shekels, we have experienced foreign exchange gains and losses to date, and may continue to incur operating gains and losses affecting net income in 2018. Depending upon the prevailing exchange rate, this translation can be significant.

In addition, while we conduct our business primarily in U.S. dollars, some of our agreements are denominated in foreign currencies, which could have an adverse effect on the revenues and costs that we incur in foreign currencies. We do not hold or issue derivative financial instruments for trading or speculative purposes.

ITEM 4. CONTROLS AND PROCEDURES.

As of the end of the period covered by this report, an evaluation was carried out by the Company’s management, with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that these disclosure controls and procedures were effective as of the end of the period covered by this report. In addition, no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II**ITEM 6. EXHIBITS.**

The following documents are filed as exhibits to or furnished with this report:

Exhibit Number	Description	
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
32.1	Certifications required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. Section 1350), executed by Dean M. Krutty, President and Chief Executive Officer of Arotech Corporation	Furnished with this Report
32.2	Certifications required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. Section 1350), executed by Kelli L. Kellar, Vice President – Finance and Chief Financial Officer of Arotech Corporation	Furnished with this Report
101.INS	XBRL Instance Document	Filed Herewith
101.SCH	XBRL Taxonomy Extension Schema Document	Filed Herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	Filed Herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	Filed Herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	Filed Herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	Filed Herewith

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: November 7, 2018

AROTECH CORPORATION

By: /s/ Dean M. Krutty

Name: Dean M. Krutty

Title: President and Chief Executive Officer
(Principal Executive Officer)

By: /s/ Kelli L. Kellar

Name: Kelli L. Kellar

Title: Vice President – Finance and CFO
(Principal Financial Officer)

CERTIFICATION

I, Dean M. Krutty, 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 controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this 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: November 7, 2018

/s/ Dean M. Krutty

Dean M. Krutty, President and Chief Executive Officer
(Principal Executive Officer)

CERTIFICATION

I, Kelli L. Kellar, 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 controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this 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: November 7, 2018

/s/ Kelli L. Kellar

Kelli L. Kellar, Vice President – Finance and CFO
(Principal Financial Officer)

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

In connection with the Quarterly Report of Arotech Corporation (the "Company") on Form 10-Q for the quarterly period ended September 30, 2018 as filed with the Securities and Exchange Commission (the "Report"), I, Dean M. Krutty, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, based on my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and,
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 7, 2018

/s/ Dean M. Krutty

Dean M. Krutty, President and Chief Executive Officer
(Principal Executive Officer)

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

In connection with the Quarterly Report of Arotech Corporation (the "Company") on Form 10-Q for the quarterly period ended September 30, 2018 as filed with the Securities and Exchange Commission (the "Report"), I, Kelli L. Kellar, Vice President – Finance and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, based on my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934;
and,
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 7, 2018

/s/ Kelli L. Kellar

Kelli L. Kellar, Vice President –
Finance and CFO
(Principal Financial Officer)