

Edgar Filing: AROTECH CORP - Form 10-K/A

AROTECH CORP
Form 10-K/A
November 29, 2004

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K/A

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2003.

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission File Number: 0-23336

AROTECH CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

95-4302784

(State or other jurisdiction
of incorporation or organization)

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

250 West 57th Street, New York, New York

10107

(Address of principal executive offices)

(Zip Code)

(212) 258-3222

(Registrant's telephone number, including area code)

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

Title of each class

Name of each exchange on which registered

None

Not applicable

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

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

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

Edgar Filing: AROTECH CORP - Form 10-K/A

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

The aggregate market value of the registrant's voting stock held by non-affiliates of the registrant as of June 30, 2003 was approximately \$31,017,725 (based on the last sale price of such stock on such date as reported by The Nasdaq National Market).

(Applicable only to corporate registrants) Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 62,312,796 as of 3/23/04

Documents incorporated by reference: None

=====

PRELIMINARY NOTE

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

Electric Fuel(R) is a registered trademark and Arotech(TM) is a trademark of Arotech Corporation, formerly known as Electric Fuel Corporation. All company and product names mentioned may be trademarks or registered trademarks of their respective holders. Unless otherwise indicated, "we," "us," "our" and similar terms refer to Arotech and its subsidiaries.

PART II

ITEM 6. SELECTED FINANCIAL DATA

The selected financial information set forth below with respect to the consolidated financial statements for each of the five fiscal years in the period ended December 31, 2003, and with respect to the balance sheets at the end of each such fiscal year has been derived from our consolidated financial statements audited by Kost, Forer, Gabbay & Kassierer, independent registered public accounting firm and a member firm of Ernst & Young Global.

The results of operations, including revenue, operating expenses, and financial income of the consumer battery segment for the years ended December 31, 2003, 2002, 2001, 2000 and 1999 have been reclassified in the accompanying statements of operations as discontinued operations. Our balance sheets at December 31, 2003, 2002, 2001, 2000 and 1999 give effect the assets of the consumer battery business as discontinued operations within current assets and liabilities. Thus, the financial information presented herein includes only continuing operations.

Edgar Filing: AROTECH CORP - Form 10-K/A

As discussed in Note 1.b. to the Consolidated Financial Statements contained in Item 8 of this Report, the Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated for the matters set forth therein.

The financial information set forth below is qualified by and should be read in conjunction with the Consolidated Financial Statements contained in Item 8 of this Report and the notes thereto and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations," below.

	Year Ended December 31,			
	1999	2000	2001	2002
	(dollars in thousands, except per share d			
Statement of Operations Data:				
Revenues	\$ 2,422	\$ 1,490	\$ 2,094	\$ 6,407
Research and development expenses and costs of revenues	3,867	1,985	2,448	5,108
Selling, general and administrative expenses and amortization of intangible assets	2,754	3,434	3,934	5,982
Operating loss	(4,198)	(3,929)	(4,288)	(4,683)
Financial income (expenses), net	190	544	263	100
Loss before minority interest in (loss) earnings of subsidiary and tax expenses	(4,008)	(3,385)	(4,026)	(4,583)
Taxes on income	(6)	--	--	--
Minority interest in (loss) earnings of subsidiary	--	--	--	(355)
Loss from continuing operations	(4,014)	(3,385)	(4,026)	(4,938)
Income (loss) from discontinued operations	(2,902)	(8,596)	(13,261)	(13,566)
Net loss for the period	(6,916)	(11,981)	(17,287)	(18,504)
Deemed dividend to certain shareholders of common stock	--	--	(1,197)	--
Net loss attributable to shareholders of common stock	\$ (6,916)	\$ (11,981)	\$ (18,483)	\$ (18,504)
Basic and diluted net loss per share from continuing operations	\$ (0.28)	\$ (0.18)	\$ (0.21)	\$ (0.15)
Loss per share for combined operations	\$ (0.48)	\$ (0.62)	\$ (0.76)	\$ (0.57)
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands)	14,334	19,243	24,200	32,382

	Year Ended December 31,			
	1999	2000	2001	2002

Balance Sheet Data:

Edgar Filing: AROTECH CORP - Form 10-K/A

Cash, cash equivalents, investments in				
marketable debt securities and restricted				
collateral deposits	\$ 2,556	\$ 11,596	\$ 12,672	\$ 2,091
Receivables and other assets*	5,215	13,771	11,515	7,895
Property and equipment, net of depreciation ...	2,258	2,289	2,221	2,555
Goodwill and other intangible assets, net	--	--	--	7,522
	-----	-----	-----	-----
Total assets	\$ 10,029	\$ 27,656	\$ 26,408	\$ 20,063
	=====	=====	=====	=====
Current liabilities*	\$ 3,427	\$ 4,787	\$ 3,874	\$ 7,272
Long-term liabilities	2,360	2,791	3,126	3,753
Stockholders' equity	4,242	20,078	19,408	9,038
	-----	-----	-----	-----
Total liabilities and stockholders equity*	\$ 10,029	\$ 27,656	\$ 26,408	\$ 20,063
	=====	=====	=====	=====

 *Includes assets and liabilities, as applicable, from discontinued operations.
 **Restated (see Note 1.b. of Notes to Consolidated Financial Statements).

- 2 -

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

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 files such reports and filings with the SEC. Our website address is 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 Consolidated Financial Statements contained in Item 8 of this report, and the notes thereto. We have rounded amounts reported here to the nearest thousand, unless such amounts are more than 1.0 million, in which event we have rounded such amounts to the nearest hundred thousand.

General

We are a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and

Edgar Filing: AROTECH CORP - Form 10-K/A

commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate in three business units:

- >> we develop, manufacture and market advanced hi-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement and security personnel, as well as offering security consulting and other services (our Simulation, Training and Consulting Division);
- >> we manufacture and sell Zinc-Air and lithium batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air battery technology for electric vehicles (our Battery and Power Systems Division); and
- >> we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our Armored Vehicle Division).

- 3 -

Early in 2004, we acquired two new businesses: FAAC Corporation, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (which we have placed in our Simulation, Training and Consulting Division), and Epsilon Electronic Industries, Ltd., located in Dimona, Israel, 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 (which we have placed in our Battery and Power Systems Division). Prior to the acquisition of FAAC and Epsilon, we were organized into two divisions: Defense and Security Products (consisting of IES, MDT, MDT Armor and Arocon), and Electric Fuel Batteries (consisting of EFL and EFB). We have reported our results of operations for 2003 and 2002 in accordance with these earlier divisions, and our financial results for 2003 and 2002 do not include the activities of FAAC or Epsilon.

Restatement of Previously-Issued Financial Statements

During our management's review of our interim financial statements for the period ended September 30, 2004 we, after discussion with and based on a new and revised review of accounting treatment by our independent auditors, conducted a comprehensive review of the re-pricing of warrants and grant of new warrants to certain of our investors and others during the years 2004 and 2003. As a result of that review, we, upon recommendation of our management and with the approval of the Audit Committee of our Board of Directors after discussion with our independent auditors, reconsidered the accounting related to these transactions and reclassified certain expenses as a deemed dividend, a non-cash item, instead of as general and administrative expenses due to the recognition of these transactions as capital transactions that should not be expensed. These restatements do not affect our balance sheet, shareholders' equity or cash flow statements. In addition and as a result of the remeasurement described above, we have reviewed assumptions used in the calculation of fair value of all warrants granted during the year 2003. As a result of this comprehensive review, we have decreased general and administrative expenses in the amount of \$150,000, related to errors found in the valuation of warrants granted in the litigation settlement described in Note 17.g. of the Notes to Consolidated Financial Statements for the year ended December 31, 2003.

In addition, during our management's review of our interim financial

Edgar Filing: AROTECH CORP - Form 10-K/A

statements for the period ended September 30, 2004, we also reviewed our calculation of amortization of debt discount attributable to the beneficial conversion feature associated with our convertible debentures. As a result of this review, we found errors which increased our financial expenses in the amount of \$568,000 for the year ended December 31, 2003. The errors were related to the amortization of debt discount attributable to the warrants and their related convertible debentures, whereby we understated the amount of amortization for the year ended December 31, 2003 attributable to certain of the convertible debentures.

Similar errors were also noted in our interim financial statements in the three-month period ended June 30, 2003, the nine-month period ended September 30, 2003, and the three- and six-month periods ended March 31 and June 30, 2004.

The impacts of these restatements with respect to the year ended December 31, 2003 are summarized below:

- 4 -

Statement of Operations Data:

	For the Year ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
General and administrative expenses	\$6,196,779	\$ (338,903)	\$5,857,876
Operating loss	5,408,932	(338,903)	5,070,029
Financial expenses, net	3,470,459	568,250	4,038,709
Loss from continuing operations	9,118,684	229,347	9,348,031
Net loss	9,008,274	229,347	9,237,621
Deemed dividend to certain stockholders of common stock	--	350,000	350,000
Net loss attributable to common stockholders	\$9,008,274	\$ 579,347	\$9,587,621
Basic and diluted net loss per share from continuing operations	\$ 0.23	\$ 0.01	\$ 0.24
Basic and diluted net loss per share	\$ 0.23	\$ 0.02	\$ 0.25

Balance sheet data:

	As of December 31, 2003		
	Previously Reported	Adjustment	As Restated
Other accounts payable and accrued expenses	\$ 4,321,347	\$ (150,000)	\$ 4,171,347

Edgar Filing: AROTECH CORP - Form 10-K/A

Total current liabilities	6,859,752	(150,000)	6,709,752
Convertible debenture	881,944	568,250	1,450,194
Total long term liabilities	4,066,579	568,250	4,634,829
Additional paid in capital	135,891,316	(188,903)	135,702,413
Accumulated deficit	(109,681,893)	(229,347)	(109,911,240)
Total shareholders' equity	22,044,127	(418,250)	21,625,877

Cash flow data:

	For the Year ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
Net loss	\$9,008,274	\$ 229,347	\$9,237,621
Stock based compensation related to repricing of warrants granted to investors and the grant of new warrants	388,403	(188,903)	199,500
Increase in other accounts payable and accrued expenses	1,827,668	(150,000)	1,677,668
Amortization of compensation related to beneficial conversion feature and warrants issued to holders of convertible debentures ..	3,359,987	568,250	3,928,237

- 5 -

Critical Accounting Policies

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

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

Revenue Recognition and Bad Debt

We generate revenues primarily from sales of multimedia and interactive digital training systems and use-of-force simulators specifically targeted for law enforcement and firearms training and from service contracts related to such sales; from providing lightweight armoring services of vehicles; from sale of zinc-air battery products for defense applications; and, to a lesser extent,

Edgar Filing: AROTECH CORP - Form 10-K/A

from development services and long-term arrangements subcontracted by the U.S government. We recognize revenues in respect of products when, among other things, we have delivered the goods being purchased and we believe collectibility to be reasonably assured. We do not grant a right of return to our customers. We perform ongoing credit evaluations of our customers' financial condition and we require collateral as deemed necessary. We make judgments as to our ability to collect outstanding receivables and provide allowances for a portion of such receivables when and if collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding receivables. In determining the provision, we analyze our historical collection experience and current economic trends. If the historical data we use to calculate the allowance provided for doubtful accounts does not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed and the future results of operations could be materially affected.

Revenues from development services are recognized using contract accounting on a percentage of completion method, based on completion of agreed-upon milestones and in accordance with the "Output Method" or based on the time and material basis. Provisions for estimated losses on uncompleted contracts are recognized in the period in which the likelihood of such losses is determined.

The complexity of the estimation process and the issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our consolidated financial statements.

- 6 -

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2003, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

Our business acquisitions typically result in the recognition of goodwill and other intangible assets, which affect the amount of current and future period charges and amortization expenses. The determination of value of these components of a business combination, as well as associated asset useful lives, requires our management to make various estimates and assumptions. Estimates using different, but each reasonable, assumptions could produce significantly different results. We test goodwill for possible impairment on an annual basis and at any other time if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying

Edgar Filing: AROTECH CORP - Form 10-K/A

amount. Such impairment loss is measured by comparing the recoverable amount of an asset with its carrying value. The determination of the value of goodwill requires our management to make assumptions regarding estimated future cash flows and other factors to determine the fair value of a respective asset. If these estimates or the related assumptions change in the future, we could be required to record impairment charges. Any material change in our valuation of assets in the future and any consequent adjustment for impairment could have a material adverse impact on our future reported financial results.

Impairment of long-lived assets and intangibles

Long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. As of December 31, 2003, no impairment losses have been identified.

The determination of the value of such long-lived and intangible assets requires management to make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. These estimates have been based on our business plans for the entities acquired. If these estimates or the related assumptions change in the future, we could be required to record impairment charges. Any material change in our valuation of assets in the future and any consequent adjustment for impairment could have a material adverse impact on our future reported financial results.

- 7 -

Functional Currency

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

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

Executive Summary

The following executive summary includes, where appropriate, discussion of our new subsidiaries, FAAC Incorporated, Epsilon Electronic Industries, Ltd. and Armour of America Incorporated, that we purchased in 2004. The results of these

Edgar Filing: AROTECH CORP - Form 10-K/A

subsidiaries are not included in our results of operations for 2003 and 2002, but are included in this discussion to the extent that they are relevant to our anticipated financial condition and results of operations going forward.

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, Training and Consulting Division, consisting of:

- o IES Interactive Training, Inc., located in Littleton, Colorado, which provides specialized "use of force" training for police, security personnel and the military ("IES");
- 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
- o Arocon Security Corporation, located in New York, New York, which provides security consulting and other services, focusing on protecting life, assets and operations with minimum hindrance to personal freedom and daily activities ("Arocon").

- 8 -

>> Our Battery and Power Systems Division, consisting of:

- 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");
- 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"); 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").

>> Our Armored Vehicle Division, consisting of:

- 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 cars, and is a leading supplier to the Israeli military, Israeli special forces and special services ("MDT") (75.5% owned);

Edgar Filing: AROTECH CORP - Form 10-K/A

- o MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT's United States activities ("MDT Armor") (88% owned); and
- o Armour of America, located in Los Angeles, California, which manufactures aviation armor both for helicopters and for fixed wing aircraft, marine armor, personnel armor, armoring kits for military vehicles, fragmentation blankets and a unique ballistic/flotation vest (ArmourFloat) that is U.S. Coast Guard-certified ("AoA").

Prior to the acquisition of FAAC and Epsilon, we were organized into two divisions: Defense and Security Products (consisting of IES, MDT, MDT Armor and Arocon), and Electric Fuel Batteries (consisting of EFL and EFB). We have reported our results of operations for 2003 and 2002 in accordance with these earlier divisions.

- 9 -

Overview of Results of Operations

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

During 2003, we substantially increased our revenues and reduced our net loss, from \$18.5 million in 2002 to \$9.2 million in 2003. This was achieved through a combination of cost-cutting measures and increased revenues, particularly from the sale of Zinc-Air batteries to the military and from sales of interactive training systems by IES. We believe that our new acquisitions, FAAC and Epsilon, will contribute to our goal of achieving profitability.

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

A portion of our operating loss during 2003 arose as a result of non-cash charges. These charges were primarily related to our acquisitions and to our raising capital. Because we anticipate continuing these activities during 2004, 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. Such non-cash charges will continue during 2004; additionally, our acquisitions of FAAC and Epsilon will result in our incurring similar non-cash charges beginning in 2004.

Edgar Filing: AROTECH CORP - Form 10-K/A

As a result of the application of the above accounting rule, we incurred non-cash charges in the amount of \$865,000 during 2003. See "Critical Accounting Policies - Goodwill," above.

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

- 10 -

As a result of the application of the above accounting rule, we incurred non-cash charges in the amount of \$3.9 million during 2003.

Additionally, in an effort to improve our cash situation and our shareholders' equity, and in order to reduce the number of our outstanding warrants, during 2003 we induced holders of certain of our warrants to exercise their warrants by lowering the exercise price of the warrants to approximately market value in exchange for immediate exercise of such warrants, and by issuing to such investors a lower number of new warrants at a higher exercise price. Under such circumstances, we record a deemed dividend in an amount determined based upon the fair value of the new warrants. 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 and grant of new warrants in the amount of \$350,000 during 2003.

We also incurred a non-cash charge in the amount of \$689,000 during 2003 arising out of the shares and warrants we granted to IES Electronics in connection with the settlement of our litigation with them. The expense in the amount above was determined based upon the fair value of these warrants and shares. This charge is not expected to recur.

Overview of Financial Condition and Operating Performance

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 Defense and Security Products Division, MDT experienced a slowdown in revenues during 2003 because MDT's primary customer, the Israel Defense Forces, reduced orders as a result of cuts in that portion of its budget that it can spend in Israel. We noted this trend in 2003 and began to work on reversing it by opening production facilities for MDT Armor in Auburn, Alabama. As of December 31, 2003, our backlog for MDT totaled \$931,000, most of which was from

Edgar Filing: AROTECH CORP - Form 10-K/A

orders from customers other than the Israel Defense Forces.

IES had record sales in 2003; IES sales have grown from \$3.5 million in 2001 (before we owned it) to more than \$8.0 million in 2003. We attribute this to a number of substantial orders, such as orders from the German Police and from the United States Department of Health and Human Services. Since sales of new IES simulation systems (as opposed to upgrades and add-ons) have a very long sales cycle, it is difficult to predict what sales will be like in 2004. As of December 31, 2003, our backlog for IES totaled \$334,000.

In our Electric Fuel Batteries Division, EFB had its first sales in 2003. These sales were almost exclusively from the United States Army, which continues to use our BA-8180 Zinc-Air battery for its CECOM division. We believe the war in Iraq had a substantial positive effect on our sales in 2003. However, we are hopeful that since the war came at a time when we were just beginning the introduction of our batteries to the Army, much of the falloff in use of our products that would normally be expected to occur at the war's end (which is not presently anticipated to occur in the immediate future) will be offset by growing acceptance of our batteries by soldiers in the field and their supply officers. As of December 31, 2003, our backlog for EFB totaled \$5.3 million.

- 11 -

We do not anticipate a substantial change in our revenues from EFL, either from the water-activated battery line or from the electric vehicle. In this connection, we have begun an effort to find external financing for development of our electric vehicle in the form of a partnership or joint venture, but there can be no assurance that we will succeed in this effort, and we do not anticipate that our electric vehicle program will provide significant revenues in 2004.

We anticipate that our acquisitions of Epsilor and FAAC, which occurred in January 2004, will add to our revenues, our gross profit and our cash flow in 2004.

Results of Operations

Preliminary Note

Results for the years ended December 31, 2003 and 2002 include the results of IES and MDT for such periods as a result of our acquisitions of these companies early in the third quarter of 2002. However, the results of IES and MDT were not included in our operating results for the full year ended December 31, 2002. Accordingly, the following year-to-year comparisons should not necessarily be relied upon as indications of future performance.

In addition, results are net of the operations of the retail consumer battery products, which operations were discontinued in the third quarter of 2002.

Following is a table summarizing our results of operations for the years ended December 31, 2003 and 2002, after which we present a narrative discussion and analysis:

	Year Ended December 31,	
	2003*	2002
Revenues:		
Defense and Security Products	\$11,457,741	\$ 4,724,443

Edgar Filing: AROTECH CORP - Form 10-K/A

Electric Fuel Batteries	5,868,899	1,682,296
All other	--	--
	-----	-----
	\$17,326,641	\$ 6,406,739
Cost of revenues:		
Defense and Security Products	\$ 6,566,252	\$ 2,380,387
Electric Fuel Batteries	4,521,588	2,041,361
All other	--	--
	-----	-----
	\$11,087,840	\$ 4,421,748
Research and development expenses.:		
Defense and Security Products	\$ 216,800	\$ 175,796
Electric Fuel Batteries	836,608	510,123
All other	--	--
	-----	-----
	\$ 1,053,408	\$ 685,919

- 12 -

	Year Ended December 31,	
	2003*	2002
	-----	-----
Sales and marketing expenses:		
Defense and Security Products	\$ 2,418,017	\$ 636,066
Electric Fuel Batteries	926,872	673,601
All other	187,747	--
	-----	-----
	\$ 3,532,636	\$ 1,309,669
General and administrative expenses:		
Defense and Security Products	\$ 1,519,458	\$ 833,610
Electric Fuel Batteries	188,655	89,945
All other	4,149,763	3,099,548
	-----	-----
	\$ 5,857,876	\$ 4,023,103
Financial expense (income):		
Defense and Security Products	\$ (139,668)	\$ (4,556)
Electric Fuel Batteries	7,936	--
All other	4,170,441	(95,895)
	-----	-----
	\$ 4,038,709	\$ (100,451)
Tax expenses:		
Defense and Security Products	\$ 393,303	\$ --
Electric Fuel Batteries	--	--
All other	2,890	--
	-----	-----
	\$ 396,193	\$ --
Amortization of intangible assets:		
Defense and Security Products	\$ 864,910	\$ 649,543
Electric Fuel Batteries	--	--
All other	--	--
	-----	-----
	\$ 864,910	\$ 649,543
Minority interest in loss (profit) of subsidiaries:		
Defense and Security Products	\$ 156,900	\$ (355,360)
Electric Fuel Batteries	--	--
All other	--	--

Edgar Filing: AROTECH CORP - Form 10-K/A

	-----	-----
	\$ 156,900	\$ (355,360)
Net loss from continuing operations:		
Defense and Security Products	\$ 224,431	\$ 301,765
Electric Fuel Batteries	612,760	1,632,734
All other	8,510,840	3,003,653
	-----	-----
	\$ 9,348,031	\$ 4,938,152
Net loss (profit) from discontinued operations:		
Defense and Security Products	\$ --	\$ --
Electric Fuel Batteries	(110,410)	13,566,206
All other	--	--
	-----	-----
	\$ (110,410)	\$ 13,566,206
Net loss:		
Defense and Security Products	\$ 224,431	\$ 301,765
Electric Fuel Batteries	502,350	15,198,940
All other	8,510,840	3,003,653
	-----	-----
	\$ 9,237,621	\$ 18,504,358
	=====	=====

 * Restated (see Note 1.b. of Notes to Consolidated Financial Statements).

Fiscal Year 2003 compared to Fiscal Year 2002

Revenues. During 2003, we (through our subsidiaries) recognized revenues as follows:

- >> IES recognized revenues from the sale of interactive use-of-force training systems and from the provision of warranty services in connection with such systems;
- >> MDT recognized revenues from payments under vehicle armoring contracts and for service and repair of armored vehicles;
- >> EFB recognized revenues from the sale of batteries and adapters to the military, and under certain development contracts with the U.S. Army;
- >> Arocon recognized revenues under consulting agreements; and
- >> EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase III of the United States Department of Transportation (DOT) electric bus program, which began in October 2002 and was completed in March 2004. Phase IV of the DOT program, which began in October 2003, did not result in any revenues during 2003.

Revenues from continuing operations for the year ended December 31, 2003 totaled \$17.3 million, compared to \$6.4 million for 2002, an increase of \$10.9 million, or 170%. This increase was primarily the result of increased sales attributable to IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002.

In 2003, revenues were \$11.5 million for the Defense and Security Products Division (compared to \$4.7 million in 2002, an increase of \$6.7 million, or 143%, due primarily to increased sales on the part of IES, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002), and \$5.9 million for the Electric Fuel Batteries Division (compared to

Edgar Filing: AROTECH CORP - Form 10-K/A

\$1.7 million in the comparable period in 2002, an increase of \$4.2 million, or 249%, due primarily to increased sales to the U.S. Army on the part of EFB).

Cost of revenues and gross profit. Cost of revenues totaled \$11.1 million during 2003, compared to \$4.4 million in 2002, an increase of \$6.7 million, or 151%, due to increased cost of goods sold, particularly by IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002.

Direct expenses for our two divisions during 2003 were \$10.9 million for the Defense and Security Products Division (compared to \$4.4 million in 2002, an increase of \$6.5 million, or 150%, due primarily to increased sales attributable to IES, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002), and \$5.9 million for the Electric Fuel Batteries Division (compared to \$3.1 million in the comparable period in 2002, an increase of \$2.9 million, or 94%, due primarily to increased sales on the part of EFB to the U.S. Army).

Gross profit was \$6.2 million during 2003, compared to \$2.0 million during 2002, an increase of \$4.3 million, or 214%. This increase was the direct result of all factors presented above, most notably the increased sales of IES and EFB, as well as the inclusion of IES and MDT in our results for the full year of 2003 but only part of 2002. In 2003, IES contributed \$4.1 million to our gross profit, EFB contributed \$1.6 million, and MDT contributed \$833,000.

- 13 -

Research and development expenses. Research and development expenses for 2003 were \$1.1 million, compared to \$686,000 in 2002, an increase of \$367,000, or 54%. This increase was primarily because certain research and development personnel who had worked on the discontinued consumer battery operations during 2002 (the expenses of which are not reflected in the 2002 number above) were reassigned to military battery research and development in 2003.

Sales and marketing expenses. Sales and marketing expenses for 2003 were \$3.5 million, compared to \$1.3 million in 2002, an increase of \$2.2 million, or 170%. This increase was primarily attributable to the following factors:

- >> The inclusion of the sales and marketing expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;
- >> An increase in IES's sales activity during 2003, which resulted in both increased sales and increased sales and marketing expenses during 2003; and
- >> We incurred expenses for consultants in the amount of \$810,000 in connection with our CECOM battery program with the U.S. Army and \$345,000 in connection with our security consulting business.

General and administrative expenses. General and administrative expenses for 2003 were \$5.9 million, compared to \$4.0 million in 2002, an increase of \$1.8 million, or 46%. This increase was primarily attributable to the following factors:

- >> The inclusion of the general and administrative expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;
- >> Expenses in 2003 in connection with a litigation settlement agreement, in the amount of \$714,000, that were not present in 2002;

Edgar Filing: AROTECH CORP - Form 10-K/A

- >> Expenses in 2003 in connection with warrant grants, in the amount of \$199,500, that were not present in 2002;
- >> Legal and consulting expenses in 2003 in connection with our convertible debentures, in the amount of \$484,000, that were not present in 2002; and
- >> Expenses in 2003 in connection with the start-up of our security consulting business in the United States and with the beginning of operations of MDT Armor, in the amount of \$250,000, that were not present in 2002.

Financial income (expense). Financial expense totaled approximately \$4.0 million in 2003 compared to financial income of \$100,000 in 2002, an increase of \$4.1 million. This increase was due primarily to amortization of compensation related to the issuance of convertible debentures issued in December 2002 and during 2003 in the amount of \$3.9 million, and interest expenses related to those debentures in the amount of \$376,000.

Tax expenses. We and our Israeli subsidiary EFL incurred net operating losses during 2003 and 2002 and, accordingly, we were not required to make any provision for income taxes. MDT and IES had taxable income, and accordingly we were required to make provision for income taxes in the amount of \$396,000 in 2003. We were able to offset IES's federal taxes against our loss carryforwards. In 2002 we did not accrue any tax expenses due to our belief that we would be able to utilize our loss carryforwards against MDT's taxable income, estimation was revised in 2003. Of the amount accrued in 2003, approximately \$352,000 was accrued on account of income in 2002.

- 14 -

Amortization of intangible assets and in-process research and development. Amortization of intangible assets totaled \$865,000 in 2003, compared to \$649,000 in 2002, an increase of \$215,000, or 33%, resulting from amortization of these assets subsequent to our acquisition of IES and MDT in 2002. Of this \$215,000 increase, \$169,000 was attributable to IES and \$46,000 was attributable to MDT.

Loss from continuing operations. Due to the factors cited above, we reported a net loss from continuing operations of \$9.3 million in 2003, compared to a net loss of \$4.9 million in 2002, an increase of \$4.4 million, or 90%.

Profit (loss) from discontinued operations. In the third quarter of 2002, we decided to discontinue operations relating to the retail sales of our consumer battery products. Accordingly, all revenues and expenses related to this segment have been presented in our consolidated statements of operations for the years ended December 31, 2003 and 2002 in an item entitled "Loss from discontinued operations."

Profit from discontinued operations in 2003 was \$110,000, compared to a net loss of \$13.6 million in 2002, a decrease of \$13.7 million. This decrease was the result of the elimination of the losses from these discontinued operations beginning with the fourth quarter of 2002. The profit from discontinued operations was primarily from cancellation of past accruals made unnecessary by the closing of the discontinued operations.

Net loss before deemed dividend. Due to the factors cited above, we reported a net loss before deemed dividend of \$9.2 million in 2003, compared to a net loss of \$18.5 million in 2002, a decrease of \$9.3 million, or 50%.

Net loss after deemed dividend of common stock to certain stockholders.

Edgar Filing: AROTECH CORP - Form 10-K/A

Due to the factors cited above, we reported a net loss after deemed dividend of \$9.6 million in 2003, compared to a net loss of \$18.5 million in 2002, a decrease of \$8.9 million, or 48%.

Fiscal Year 2002 compared to Fiscal Year 2001

Revenues. Revenues from continuing operations for the year ended December 31, 2002 totaled \$6.4 million, compared to \$2.1 million for 2001, an increase of \$4.3 million, or 206%. This increase was primarily the result of the inclusion of IES and MDT in our results in 2002.

During 2002, we recognized revenues from the sale of interactive use-of-force training systems (through our IES subsidiary), from payments under vehicle armoring contracts (through our MDT subsidiary), and from the sale of lifejacket lights, as well as under contracts with the U.S. Army's CECOM for deliveries of batteries and for design and procurement of production tooling and equipment. We also recognized revenues from subcontracting fees received in connection with Phase II of the United States Department of Transportation (DOT) program, which began in the fourth quarter of 2001 and was completed in July 2002, and Phase III of the DOT program, which began in October 2002. We participate in this program as a member of a consortium seeking to demonstrate the ability of the Electric Fuel battery system to power a full-size, all-electric transit bus. The total program cost of Phase II was \$2.7 million, 50% of which was covered by the DOT subcontracting fees. Subcontracting fees cover less than all of the expenses and expenditures associated with our participation in the program. In 2001, we derived revenues principally from the sale of lifejacket lights, under contracts with the U.S. Army's CECOM for deliveries of batteries and for design and procurement of production tooling and equipment and from subcontracting fees received in connection with the DOT program.

- 15 -

In 2002, revenues were \$4.7 million for the Defense and Security Products Division (compared to \$0 in 2001), due to the inclusion of IES and MDT in our 2002 results, and \$1.7 million for the Electric Fuel Batteries Division (compared to \$2.1 million in the comparable period in 2001, a decrease of \$411,000, or 20%), due primarily to \$471,000 in revenues from a German consortium project relating to our electric vehicle that were included in 2001 but that did not exist in 2002. Of the \$4.7 million increase in Defense and Security Products revenues, \$2.0 million was attributable to the inclusion of IES in our results in 2002 and \$2.7 million was attributable to the inclusion of MDT in our results in 2002.

Cost of revenues and gross profit. Cost of revenues totaled \$4.4 million during 2002, compared to \$2.0 million in 2001, an increase of \$2.4 million, or 122%, due to the inclusion of IES and MDT in our 2002 results.

Direct expenses for our two divisions during 2002 were \$4.4 million for the Defense and Security Products Division (compared to \$0 in 2001), due to the inclusion of IES and MDT in our 2002 results, and \$3.1 million for the Electric Fuel Batteries Division (compared to \$2.3 million in the comparable period in 2001, an increase of \$767,000, or 33%), due primarily to the following factors:

- >> We began to ramp up production at our CECOM facility in Alabama in anticipation of the CECOM order that we received in December 2002; and
- >> We wrote off certain disqualified CECOM inventory in the amount of \$116,000.

Edgar Filing: AROTECH CORP - Form 10-K/A

Of the \$4.4 million increase in Defense and Security Products direct expenses, \$2.1 million was attributable to the inclusion of IES in our results in 2002 and \$2.3 million was attributable to the inclusion of MDT in our results in 2002.

Gross profit was \$2.0 million during 2002, compared to \$101,000 during 2001, an increase of \$1.9 million. This increase was the direct result of all factors presented above, most notably the inclusion of IES and MDT in our 2002 results. In 2002, IES contributed \$1.3 million to our gross profit, and MDT contributed \$1.1 million, which was offset by a gross loss of \$360,000 in our other divisions.

Research and development expenses. Research and development expenses for 2002 were \$686,000, compared to \$456,000 in 2001, an increase of \$230,000, or 50%. This increase was primarily the result of the inclusion of IES, which accounted for \$130,000 of the increase, in our 2002 results.

- 16 -

Sales and marketing expenses. Sales and marketing expenses for 2002 were \$1.3 million, compared to \$106,000 in 2001, an increase of \$1.2 million, or 1,136%. This increase was primarily attributable to the following factors:

- >> We had sales and marketing expenses in 2002 related to IES of \$572,000, which we did not have in 2001;
- >> We had sales and marketing expenses in 2002 related to MDT of \$63,000, which we did not have in 2001; and
- >> We incurred expenses for consultants, primarily lobbyists, in the amount of \$128,000 in connection with our Electric Vehicle program and \$441,000 in connection with our CECOM battery program with the U.S. Army.

General and administrative expenses. General and administrative expenses for 2002 were \$4.0 million compared to \$3.8 million in 2001, an increase of \$196,000, or 5%. This increase was primarily attributable to the inclusion of IES and MDT in our results beginning with the third quarter, which increased general and administrative expenses by approximately \$839,000. This increase was offset by a decrease in general and administrative expenses of \$643,000, resulting from:

- >> the dismissal of our litigation with Electrofuel Inc., which resulted in a decrease in litigation-related legal expenses; and
- >> the settlement of our dispute with a former employee on terms that resulted in a savings to us over the amount that we had set aside on our books.

Financial income. Financial income, net of interest expenses and exchange differentials, totaled approximately \$100,000 in 2002 compared to \$263,000 in 2001, a decrease of \$163,000, or 62%. This decrease was due primarily to lower interest rates and lower balances of invested funds as a result of our use of the proceeds of private placements of our securities.

Income taxes. We and our Israeli subsidiary EFL incurred net operating losses during 2002 and 2001 and, accordingly, we were not required to make any provision for income taxes. MDT had taxable income, but we may use EFL's losses to offset MDT's income, and accordingly MDT has made no provision for income

Edgar Filing: AROTECH CORP - Form 10-K/A

taxes.

Amortization of intangible assets. Amortization of intangible assets totaled \$649,000 in 2002, compared to \$0 in 2001, due to the inclusion of IES and MDT in our 2002 results. Of this \$649,000 increase, \$551,000 was attributable to the inclusion of IES in our results in 2002 and \$98,000 was attributable to the inclusion of MDT in our results in 2002.

- 17 -

Loss from continuing operations. Due to the factors cited above, we reported a net loss from continuing operations of \$4.9 million in 2002, compared to a net loss of \$4.0 million in 2001, an increase of \$913,000, or 22%.

Loss from discontinued operations. In the third quarter of 2002, we decided to discontinue operations relating to the retail sales of our consumer battery products. Accordingly, all revenues and expenses related to this segment have been presented in our consolidated statements of operations for the year ended December 31, 2002 in an item entitled "Loss from discontinued operations."

Loss from discontinued operations in 2002 was \$13.6 million, compared to \$13.3 million in 2001, an increase of \$306,000, or 2%. This increase was the result of a write-off of fixed inventory and assets in the amount of \$7.1 million in connection with our discontinuation of the operations relating to the retail sales of our consumer battery products at the end of the third quarter of 2002, which was not entirely offset by the elimination of the losses from these discontinued operations beginning with the fourth quarter of 2002.

Net loss. Due to the factors cited above, we reported a net loss of \$18.5 million in 2002, compared to a net loss of \$17.3 million in 2001, an increase of \$1.2 million, or 7%.

Liquidity and Capital Resources

As of December 31, 2003, we had cash and cash equivalents of approximately \$13.7 million, compared with \$1.5 million as of December 31, 2002, an increase of \$12.2 million, or 839%. The increase in cash was primarily the result of sales of our securities during 2003. In January 2004, we raised an additional \$17.8 million, net of expenses, through additional sales of our securities. As of February 29, 2004, our cash totaled approximately \$4.2 million, not including approximately \$9.1 million held in restricted deposits to fund future obligations in connection with such acquisitions, primarily as a result of our use of cash for the Epsilon and FAAC acquisitions.

We used available funds in 2003 primarily for working capital needs. We increased our investment in fixed assets by \$585,000 during the year ended December 31, 2003, primarily in the Electric Fuel Batteries Division. Our fixed assets amounted to \$2.3 million as at year end.

Net cash used in operating activities from continuing operations for 2003 and 2002 was \$3.0 million and \$3.5 million, respectively, a decrease of \$465,000, or 13%. This decrease was primarily the result of changes in operating assets and liabilities, such as accounts payable and inventory.

Net cash used in investing activities for 2003 and 2002 was \$1.8 million and \$5.4 million, respectively, a decrease of \$3.6 million, or 66%. This decrease was primarily the result of our investment in the acquisition of IES and MDT in 2002.

Net cash provided by financing activities for 2003 and 2002 was \$17.4

Edgar Filing: AROTECH CORP - Form 10-K/A

million and \$3.1 million, respectively, an increase of \$14.3 million, or 464%. This increase was primarily the result of higher amounts of funds raised through sales of our securities in 2003 compared to 2002.

- 18 -

During 2003, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately \$434,000.

On September 30, 2003 we issued and sold to various institutional investors an aggregate \$5,000,000 principal amount of 8% Secured Convertible Debentures due September 30, 2006, as more fully described in the Current Report on Form 8-K that we filed with the Securities and Exchange Commission on October 3, 2003.

On December 18, 2002 we issued and sold to various institutional investors an aggregate \$6,000,000 principal amount of 8% Secured Convertible Debentures due December 31, 2006, as more fully described under "Item 5. Market For Registrant's Common Equity and Related Stockholder Matters - Recent Sales of Unregistered Securities," above.

We have approximately \$10.5 million in long term debt outstanding, of which \$8.4 million was convertible debt, and approximately \$6.9 million in short-term debt.

We believe that our present cash position and anticipated cash flows from operations should be sufficient to satisfy our current estimated cash requirements through the next year. 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.

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

Effective Corporate Tax Rate

Arotech and EFL have incurred net operating losses or had earnings arising from tax-exempt income during the years ended December 31, 2001, 2002 and 2003 and accordingly no provision for income taxes was required. Taxes in these entities paid in 2001, 2002 and 2003 are primarily composed of United States federal alternative minimum taxes.

As of December 31, 2003, we had U.S. net operating loss carry forwards of approximately \$17.0 million that are available to offset future taxable income, expiring primarily in 2015, and foreign net operating and capital loss carry forwards of approximately \$84.0 million, which are available indefinitely to offset future taxable income.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2003:

- 19 -

Edgar Filing: AROTECH CORP - Form 10-K/A

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More
Long-term debt*	\$8,525,000	\$ --	\$8,525,000	\$ --	\$
Short-term debt	\$ 190,849	\$ 190,849	\$ --	\$ --	\$
Operating lease obligations	\$ 590,778	\$ 393,512	\$ 197,266	\$ --	\$
Severance obligations	\$1,749,391	\$ 183,056	\$1,387,738	\$ --	\$

 * Includes convertible debentures in the gross amount of \$8,375,000. Unamortized financial expenses related to the beneficial conversion feature of these convertible debentures amounted to \$6,924,806 at year end.

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 operating losses since our inception. Additionally, as of December 31, 2003, we had an accumulated deficit of approximately \$110.0 million. There can be no assurance that we will ever be able to maintain profitability consistently or that our business will continue to exist.

Our existing indebtedness may adversely affect our ability to obtain additional funds and may increase our vulnerability to economic or business downturns.

Our indebtedness aggregated approximately \$8.7 million as of December 31, 2003. 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

Edgar Filing: AROTECH CORP - Form 10-K/A

- 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.

- 20 -

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

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

Failure to comply with the terms of our debentures could result in a default that could have material adverse consequences for us.

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

We have pledged a substantial portion of our assets to secure our borrowings.

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

We need significant amounts of capital to operate and grow our business.

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

We may not be successful in operating a new business.

Prior to the acquisitions of IES and MDT in 2002 and the acquisitions of FAAC and 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

Edgar Filing: AROTECH CORP - Form 10-K/A

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

- 21 -

Our acquisition strategy involves various risks.

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

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

We may not successfully integrate our new acquisitions.

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

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

If we are unable to manage our growth, our operating results will be impaired.

Edgar Filing: AROTECH CORP - Form 10-K/A

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.

- 22 -

A significant portion of our business is dependent on government contracts.

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

Sales to public sector customers are subject to a multiplicity of detailed regulatory requirements and public policies as well as to changes in training and purchasing priorities. Contracts with public sector customers may be conditioned upon the continuing availability of public funds, which in turn depends upon lengthy and complex budgetary procedures, and may be subject to certain pricing constraints. Moreover, U.S. government contracts and those of many international government customers may generally be terminated for a variety of factors when it is in the best interests of the government and contractors may be suspended or debarred for misconduct at the discretion of the government. There can be no assurance that these factors or others unique to government contracts or the loss or suspension of necessary regulatory licenses will not have a material adverse effect on our future results of operations and financial condition.

Our U.S. government contracts may be terminated at any time and may contain other unfavorable provisions.

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

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

have expended on our contracts.

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

- 23 -

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;
- 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. In 2003, approximately 36% of our revenues were derived from fixed-price contracts for both defense and non-defense related government contracts. Often, we are required to fix the price for a contract before we finalize the project specifications, which increases the risk that we will mis-price these contracts. The complexity of many of our engagements makes accurately estimating our time and resources more difficult.

- 24 -

If we are unable to retain our contracts with the U.S. government and subcontracts under U.S. government prime contracts in the competitive rebidding process, our revenues may suffer.

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

Some of the components of our products pose potential safety risks which could create potential liability exposure for us.

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

We may face product liability claims.

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

Our fields of business are highly competitive.

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

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

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

- 25 -

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

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

Our business is dependent on proprietary rights that may be difficult to protect and could affect our ability to compete effectively.

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

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

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

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

- 26 -

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 2005. We do not have key-man life insurance on Mr. Ehrlich.

There are risks involved with the international nature of our business.

A significant portion of our sales are made to customers located outside the U.S., primarily in Europe and Asia. In 2003, 2002 and 2001, without taking account of revenues derived from discontinued operations, 42%, 56% and 49%, respectively, of our revenues, were derived from sales to customers located outside the U.S. We expect that our international customers will continue to account for a substantial portion of our revenues in the near future. Sales to international customers may be subject to political and economic risks, including political instability, currency controls, exchange rate fluctuations, foreign taxes, longer payment cycles and changes in import/export regulations and tariff rates. In addition, various forms of protectionist trade legislation have been and in the future may be proposed in the U.S. and certain other countries. Any resulting changes in current tariff structures or other trade and monetary policies could adversely affect our sales to international customers.

Investors should not purchase our common stock with the expectation of receiving cash dividends.

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

Market-Related Risks

The price of our common stock is volatile.

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

- 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;

- 27 -

- o Rumors relating to our competitors or us;
- o Actual or anticipated fluctuations in our operating results; and

Edgar Filing: AROTECH CORP - Form 10-K/A

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

Although we would have the opportunity to appeal any potential delisting, there can be no assurances that this appeal would be resolved favorably. As a result, there can be no assurance that our common stock will remain listed on the Nasdaq National Market. If our common stock were to be delisted from the Nasdaq National Market, we might apply to be listed on the Nasdaq SmallCap market; however, there can be no assurance that we would be approved for listing on the Nasdaq SmallCap market, which has the same \$1.00 minimum bid and other similar requirements as the Nasdaq National Market. If we were to move to the Nasdaq SmallCap market, current Nasdaq regulations would give us the opportunity to obtain an additional 180-day grace period and an additional 90-day grace period after that if we meet certain net income, stockholders' equity or market capitalization criteria. While our stock would continue to trade on the over-the-counter bulletin board following any delisting from the Nasdaq, any such delisting of our common stock could have an adverse effect on the market price of, and the efficiency of the trading market for, our common stock. Also, if in the future we were to determine that we need to seek additional equity capital, it could have an adverse effect on our ability to raise capital in the public equity markets.

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

A substantial number of our shares are available for sale in the public market and sales of those shares could adversely affect our stock price.

Sales of a substantial number of shares of common stock into the public market, or the perception that those sales could occur, could adversely affect our stock price or could impair our ability to obtain capital through an offering of equity securities. As of February 29, 2004, we had 59,904,449 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.

Edgar Filing: AROTECH CORP - Form 10-K/A

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

As of February 29, 2004, there were outstanding warrants to purchase a total of 19,302,156 shares of our common stock at a weighted average exercise price of \$1.85 per share, options to purchase a total of 9,627,212 shares of our common stock at a weighted average exercise price of \$1.48 per share, of which 6,477,440 were vested, at a weighted average exercise price of \$1.67 per share, and outstanding debentures convertible into a total of 5,203,149 shares of our common stock at a weighted average conversion price of \$1.39 per share. Holders of our options, warrants and convertible debt will probably exercise or convert them only at a time when the price of our common stock is higher than their respective exercise or conversion prices. Accordingly, we may be required to issue shares of our common stock at a price substantially lower than the market price of our stock. This could adversely affect our stock price. In addition, if and when these shares are issued, the percentage of our common stock that existing stockholders own will be diluted.

Our certificate of incorporation and bylaws and Delaware law contain provisions that could discourage a takeover.

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

- 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.

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.

- 29 -

Israel-Related Risks

A significant portion of our operations takes place in Israel, and we could be adversely affected by the economic, political and military conditions in that region.

The offices and facilities of three of our subsidiaries, EFL, MDT and Epsilor, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of our senior management is located at EFL's facilities. Although we expect that most of our

Edgar Filing: AROTECH CORP - Form 10-K/A

sales will be made to customers outside Israel, we are nonetheless directly affected by economic, political and military conditions in that country. Accordingly, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel.

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

Service of process and enforcement of civil liabilities on us and our officers may be difficult to obtain.

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

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

- 30 -

Exchange rate fluctuations between the U.S. dollar and the Israeli NIS may negatively affect our earnings.

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

Edgar Filing: AROTECH CORP - Form 10-K/A

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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Index to Financial Statements	Page

Consolidated Financial Statements	
Report of Independent Registered Public Accounting Firm.....	F-2
Consolidated Balance Sheets.....	F-3
Consolidated Statements of Operations.....	F-5
Statements of Changes in Shareholders' Equity.....	F-6
Consolidated Statements of Cash Flows.....	F-9
Notes to Consolidated Financial Statements.....	F-12
Supplementary Financial Data	
Quarterly Financial Data (unaudited) for the two years ended	
December 31, 2003.....	F-52
Financial Statement Schedule	
Schedule II - Valuation and Qualifying Accounts.....	F-53

- 31 -

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this amended report:

- (1) Financial Statements - See Index to Financial Statements on page 32 above.
- (2) Financial Statements Schedules - Schedule II - Valuation and Qualifying Accounts. All schedules other than those listed above are omitted because of the absence of conditions under which they are required or because the required information is presented in the financial statements or related notes thereto.
- (3) Exhibits - The following Exhibits are either filed herewith or have previously been filed with the Securities and Exchange Commission and are referred to and incorporated herein by reference to such filings:

Exhibit No.	Description
-----	-----
*23	Consent of Kost, Forer, Gabbay & Kassierer, a member of Ernst & Young Global
*31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Edgar Filing: AROTECH CORP - Form 10-K/A

- *32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- *32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Amended version filed herewith

- 32 -

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this amended report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 29, 2004.

AROTECH CORPORATION

By: /s/ Robert S. Ehrlich

Name: Robert S. Ehrlich
Title: Chairman, President and
Chief Executive Officer

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

Signature -----	Title -----
/s/ Robert S. Ehrlich ----- Robert S. Ehrlich	Chairman, President, Chief Executive Officer and Director (Principal Executive Officer)
/s/ Avihai Shen ----- Avihai Shen	Vice President - Finance (Principal Financial Officer)
/s/ Danny Waldner ----- Danny Waldner	Controller (Principal Accounting Officer)
/s/ Steven Esses ----- Steven Esses	Executive Vice President, Chief Operating Officer and Director
/s/ Jay M. Eastman ----- Dr. Jay M. Eastman	Director
/s/ Lawrence M. Miller ----- Lawrence M. Miller	Director

Edgar Filing: AROTECH CORP - Form 10-K/A

/s/ Jack E. Rosenfeld	Director

Jack E. Rosenfeld	
	Director

Bert W. Wasserman	
	Director

Edward J. Borey	

- 33 -

ELECTRIC FUEL CORPORATION AND ITS SUBSIDIARIES

AROTECH CORPORATION AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

IN U.S. DOLLARS

INDEX

	Page

Report of Independent Registered Public Accounting Firm	2
Consolidated Balance Sheets	3 - 4
Consolidated Statements of Operations	5
Statements of Changes in Shareholders' Equity	6 - 8
Consolidated Statements of Cash Flows	9 - 11
Notes to Consolidated Financial Statements	12 - 50

[LOGO]
ERNST & YOUNG

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

AROTECH CORPORATION

We have audited the accompanying consolidated balance sheets of Arotech Corporation (formerly known as Electric Fuel Corporation) (the "Company") and its subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in Item 15(a) (2) of the Company's 10-K/A. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public

Edgar Filing: AROTECH CORP - Form 10-K/A

Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2003 and 2002, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States. Additionally, in our opinion the related financial statement schedule, when considered in relation to the basic financial statements and schedule taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1.b., the Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated for the matters set forth therein.

Tel Aviv, Israel
November 22, 2004

KOST, FORER, GABBAY & KASSIERER
A Member of Ernst & Young Global

F - 2

AROTECH CORPORATION AND ITS SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2003	2002
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$13,685,125	\$ 1,457,
Restricted collateral deposit and other restricted cash	706,180	633,
Trade receivables (net of allowance for doubtful accounts in the amounts of \$61,282 and \$40,636 as of December 31, 2003 and 2002, respectively)	4,706,423	3,776,
Other accounts receivable and prepaid expenses	1,187,371	1,032,
Inventories	1,914,748	1,711,
Assets of discontinued operations	66,068	349,
	-----	-----
Total current assets	22,265,915	8,960,
	-----	-----
SEVERANCE PAY FUND	1,023,342	1,025,
PROPERTY AND EQUIPMENT, NET	2,292,741	2,555,

Edgar Filing: AROTECH CORP - Form 10-K/A

GOODWILL	5,064,555	4,954,
OTHER Intangible Assets, NET	2,375,195	2,567,
	-----	-----
	\$33,021,748	\$20,063,
	=====	=====

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

F - 3

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December
	2003*

LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Short term bank loans	\$ 40,849
Trade payables	1,967,448
Other accounts payable and accrued expenses	4,171,347
Current portion of promissory note	150,000
Liabilities of discontinued operations	380,108

Total current liabilities	6,709,752
LONG TERM LIABILITIES	
Accrued severance pay	2,814,492
Convertible debenture	1,450,194
Deferred warranty revenue	220,143
Promissory note	150,000

Total long-term liabilities	4,634,829
COMMITMENTS AND CONTINGENT LIABILITIES	
MINORITY INTEREST	51,290
SHAREHOLDERS' EQUITY:	
Share capital -	
Common stock - \$0.01 par value each;	
Authorized: 100,000,000 shares as of December 31, 2002 and 2001;	
Issued: 47,972,407 shares and 35,701,594 shares as of December 31,	
2003 and 2002, respectively; Outstanding - 47,417,074 shares and	
35,146,261 shares as of December 31, 2003 and 2002, respectively	479,726
Preferred shares - \$0.01 par value each;	
Authorized: 1,000,000 shares as of December 31, 2003 and 2002; No	

Edgar Filing: AROTECH CORP - Form 10-K/A

shares issued and outstanding as of December 31, 2003 and 2002		--
Additional paid-in capital		135,702,413
Accumulated deficit		(109,911,240)
Deferred stock compensation		(8,464)
Treasury stock, at cost (common stock - 555,333 shares as of December 31, 2003 and 2002)		(3,537,106)
Notes receivable from shareholders		(1,203,881)
Accumulated other comprehensive loss		104,429

Total shareholders' equity		21,625,877

		\$ 33,021,748
		=====

* Restated (see Note 1.b.).

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

F - 4

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
In U.S. dollars

	Year ended December 31,		
	2003*	2002	2001
	-----	-----	-----
Revenues:			
Products	\$ 16,918,480	\$ 5,944,370	\$ 1,600,000
Services	408,161	462,369	400,000
	-----	-----	-----
Total revenues	17,326,641	6,406,739	2,000,000
Cost of revenues	11,087,840	4,421,748	1,900,000
	-----	-----	-----
Gross profit	6,238,801	1,984,991	1,100,000
	-----	-----	-----
Operating expenses:			
Research and development, net	1,053,408	685,919	400,000
Selling and marketing expenses	3,532,636	1,309,669	1,000,000
General and administrative expenses	5,857,876	4,023,103	3,800,000
Amortization of intangible assets	864,910	623,543	--
In-process research and development write-off	--	26,000	--
	-----	-----	-----
Total operating costs and expenses	11,308,830	6,668,234	4,300,000
	-----	-----	-----

Edgar Filing: AROTECH CORP - Form 10-K/A

Operating loss	5,070,029	4,683,243	4,2
Financial income (expenses), net	(4,038,709)	100,451	2
	-----	-----	-----
Loss before minority interest in loss (earnings) of a subsidiary and tax expenses	(9,108,738)	(4,582,792)	(4,0
Tax expenses	(396,193)	--	
Minority interest in loss (earnings) of a subsidiary	156,900	(355,360)	
	-----	-----	-----
Loss from continuing operations	(9,348,031)	(4,938,152)	(4,0
Income (loss) from discontinued operations (including loss on disposal of \$4,446,684 during 2002)	110,410	(13,566,206)	(13,2
	-----	-----	-----
Net loss	\$ (9,237,621)	\$ (18,504,358)	\$ (17,2
Deemed dividend to certain shareholders of common stock	\$ (350,000)	\$ --	\$ (1,1
	-----	-----	-----
Net loss attributable to shareholders of common stock	\$ (9,587,621)	\$ (18,504,358)	\$ (18,4
	=====	=====	=====
Basic and diluted net loss per share from continuing operations	\$ (0.24)	\$ (0.15)	\$
	=====	=====	=====
Basic and diluted net loss per share from discontinued operations	\$ 0.00	\$ (0.42)	\$
	=====	=====	=====
Basic and diluted net loss per share	\$ (0.25)	\$ (0.57)	\$
	=====	=====	=====
Weighted average number of shares used in computing basic and diluted net loss per share	38,890,174	32,381,502	24,2
	=====	=====	=====

* Restated (see Note 1.b.).

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

F - 5

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit
	Shares	Amount		
	-----	-----	-----	-----
Balance as of January 1, 2001	21,422,691	\$ 214,227	\$ 89,091,790	\$ 64,882,473)
Repurchase of common shares from shareholders and repayment of the related				

Edgar Filing: AROTECH CORP - Form 10-K/A

interest and principal of notes from shareholders	--	--	228,674	--
Issuance of shares to investors, net	6,740,359	67,405	14,325,941	--
Retirement of shares	(3,000)	(30)	(17,970)	--
Issuance of shares to service providers	346,121	3,461	536,916	--
Exercise of options	219,965	2,200	512,089	--
Exercise of warrants	333,333	3,333	836,667	--
Deferred stock compensation	--	--	18,000	--
Amortization of deferred stock compensation	--	--	(6,193)	--
Stock compensation related to options issued to consultants	--	--	139,291	--
Stock compensation related to options to consultants repriced	--	--	21,704	--
Comprehensive loss:				
Net loss	--	--	--	(17,286,788)
	-----	-----	-----	-----
Total comprehensive loss				
Balance as of December 31, 2001	29,059,469	\$ 290,596	\$ 105,686,909	\$ (82,169,261)
	=====	=====	=====	=====
		Total comprehensive loss	Notes receivable from shareholders	Total shareholders' equity
		-----	-----	-----
Balance as of January 1, 2001		\$ (4,290,204)	\$ 20,078,369	
Repurchase of common shares from shareholders and repayment of the related interest and principal of notes from shareholders		3,470,431	199,730	
Issuance of shares to investors, net		--	14,393,346	
Retirement of shares		18,000	--	
Issuance of shares to service providers		--	540,377	
Exercise of options		(43,308)	470,981	
Exercise of warrants	--	--	840,000	
Deferred stock compensation		--	--	
Amortization of deferred stock compensation		--	11,047	
Stock compensation related to options issued to consultants		--	139,291	
Stock compensation related to options to consultants repriced		--	21,704	
Comprehensive loss:				
Net loss	(17,286,788)	--	(17,286,788)	
	-----	-----	-----	
Total comprehensive loss	\$ (17,286,788)			
Balance as of December 31, 2001		\$ (845,081)	\$ 19,408,057	
	=====	=====	=====	

Edgar Filing: AROTECH CORP - Form 10-K/A

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

F - 6

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
In U.S. dollars

	Common stock		Additional paid-in capital	Accumulated deficit	De s comp
	Shares	Amount			
Balance as of January 1, 2002	29,059,469	\$ 290,596	\$105,686,909	\$ (82,169,261)	\$
Adjustment of notes from shareholders					
Repayment of notes from employees	--	--	--		
Issuance of shares to investors	2,041,176	20,412	3,209,588		
Issuance of shares to service providers	368,468	3,685	539,068		
Issuance of shares to lender in respect of prepaid interest expenses	387,301	3,873	232,377	--	
Exercise of options by employees	191,542	1,915	184,435		
Amortization of deferred stock compensation					
Stock compensation related to options issued to employees	13,000	130	12,870		
Issuance of shares in respect of acquisition	3,640,638	36,406	4,056,600		
Accrued interest on notes receivable			160,737		
Other comprehensive loss Foreign currency translation adjustment					
Net loss				(18,504,358)	
Total comprehensive loss					
Balance as of December 31, 2002	35,701,594	\$ 357,017	\$114,082,584	\$ (100,673,619)	\$
	=====	=====	=====	=====	=====
	Total comprehensive loss	Notes receivable from shareholders	Accumulated other comprehensive loss	Total shareholders' equity	
	-----	-----	-----	-----	
Balance as of January 1, 2002		\$ (845,081)	--	\$ 19,408,057	
Adjustment of notes from shareholders		(178,579)		(178,579)	
Repayment of notes from					

Edgar Filing: AROTECH CORP - Form 10-K/A

employees	--	--	43,308	43,308
Issuance of shares to investors				3,230,000
Issuance of shares to service providers				542,753
Issuance of shares to lender in respect of prepaid interest expenses		--		236,250
Exercise of options by employees		(36,500)		149,850
Amortization of deferred stock compensation				6,000
Stock compensation related to options issued to employees				13,000
Issuance of shares in respect of acquisition				4,093,006
Accrued interest on notes receivable		(160,737)		--
Other comprehensive loss				
Foreign currency translation adjustment	(1,786)		(1,786)	(1,786)
Net loss	(18,504,358)			(18,504,358)
	-----	-----	-----	-----
Total comprehensive loss	\$ (18,506,144)			
	=====			
Balance as of December 31, 2002		\$ (1,177,589)	\$ (1,786)	\$ 9,037,501
	=====	=====	=====	=====

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

F - 7

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
In U.S. dollars

	Common stock		Additional	Accumulated	Def
	Shares	Amount	paid-in capital	deficit	st compe
	-----	-----	-----	-----	-----
Balance as of January 1, 2003*	35,701,594	\$ 357,017	\$114,082,584	\$ (100,673,619)	\$ (
Compensation related to warrants issued to the holders of convertible debentures			5,157,500		
Compensation related to beneficial conversion feature of convertible debentures			5,695,543		
Issuance of shares on conversion of convertible debentures	6,969,605	69,696	6,064,981		
Issuance of shares on exercise of warrants	3,682,997	36,831	3,259,422		

Edgar Filing: AROTECH CORP - Form 10-K/A

Issuance of shares to consultants	223,600	2,236	159,711		
Compensation related to warrants and options issued to consultants and investors			229,259		
Compensation related to non-recourse loan granted to shareholder			38,500		
Deferred stock compensation			4,750		
Amortization of deferred stock compensation					
Exercise of options by employees	689,640	6,896	426,668		
Exercise of options by consultants	15,000	150	7,200		
Conversion of convertible promissory note	563,971	5,640	438,720		
Increase in investment in subsidiary against common stock issuance	126,000	1,260	120,960		
Accrued interest on notes receivable from shareholders			16,615		
Other comprehensive loss - foreign currency translation adjustment					
Net loss				(9,237,621)	
	-----	-----	-----	-----	-----
Balance as of December 31, 2003	47,972,407	\$ 479,726	\$135,702,413	\$ (109,911,240)	\$
	=====	=====	=====	=====	=====
		Notes receivable from shareholders	Accumulated other comprehensive loss	Total shareholders' equity	
		-----	-----	-----	
Balance as of January 1, 2003*	\$ (1,786)		\$ 9,037,501		
Compensation related to warrants issued to the holders of convertible debentures			5,157,500		
Compensation related to beneficial conversion feature of convertible debentures			5,695,543		
Issuance of shares on conversion of convertible debentures	(9,677)		6,125,000		
Issuance of shares on exercise of warrants			3,296,253		
Issuance of shares to consultants			161,947		
Compensation related to warrants and options issued to consultants and investors			229,259		
Compensation related to non-recourse loan granted to shareholder			38,500		
Deferred stock compensation			--		
Amortization of deferred stock					

Edgar Filing: AROTECH CORP - Form 10-K/A

compensation			8,286
Exercise of options by employees			433,564
Exercise of options by consultants			7,350
Conversion of convertible promissory note			444,360
Increase in investment in subsidiary against common stock issuance			122,220
Accrued interest on notes receivable from shareholders			--
Other comprehensive loss - foreign currency translation adjustment	106,215	106,215	106,215
Net loss	-----	(9,237,621)	(9,237,621)
		(9,131,406)	
		=====	
Balance as of December 31, 2003	\$104,429		\$ 21,625,877
	=====		=====

* Restated (see Note 1.b.).

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

F - 8

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	Year ended
	2003*

Cash flows from operating activities:	
Net loss	(9,237,621)
Less loss (profit) for the period from discontinued operations	(110,410)
Adjustments required to reconcile net loss to net cash used in operating activities:	
Minority interest in earnings (loss) of subsidiary	(156,900)
Depreciation	730,159
Amortization of intangible assets	864,910
In-process research and development write-off	--
Accrued severance pay, net	3,693
Amortization of deferred stock compensation	8,286
Impairment and write-off of loans to shareholders	(12,519)
Compensation expenses related to repurchase of treasury stock	--
Write-off of inventories	96,350

Edgar Filing: AROTECH CORP - Form 10-K/A

Impairment of fixed assets	68,945
Amortization of compensation related to beneficial conversion feature and warrants issued to holders of convertible debentures	3,928,237
Amortization of deferred expenses related to convertible debenture issuance	483,713
Amortization of prepaid financial expenses	236,250
Amortization of capitalized research and development projects	14,401
Stock-based compensation related to grant of new warrants	199,500
Stock-based compensation related to repricing of warrants granted to consultants	29,759
Stock-based compensation related to shares issued to consultants	161,947
Stock-based compensation related to non-recourse note granted to stockholder	38,500
Compensation expenses related to shares issued to employees	--
Accrued interest on notes receivable from shareholders	--
Interest accrued on promissory notes due to acquisition	(66,793)
Interest accrued on restricted collateral deposit	--
Capital (gain) loss from sale of property and equipment	(11,504)
Decrease (increase) in trade receivables	(820,137)
Decrease in other accounts receivable and prepaid expenses	40,520
Increase in inventories	(193,222)
Decrease in trade payables	(986,022)
Increase (decrease) in other accounts payable and accrued expenses	1,677,668

Net cash used in operating activities from continuing operations (reconciled from continuing operations)	(3,012,290)
Net cash used in operating activities from discontinued operations (reconciled from discontinued operations)	(313,454)

Net cash used in operating activities	(3,325,744)

* Restated. (see Note 1.b.)

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

F - 9

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

Ye
2003*

Edgar Filing: AROTECH CORP - Form 10-K/A

Cash flows from investing activities:	
Purchase of property and equipment	(580,949)
Increase in capitalized research and development projects	(209,616)
Payment to suppliers for purchase of property and equipment from previous year	--
Loans granted to shareholders	(13,737)
Repayment of loans granted to shareholders	9,280
Proceeds from sale of property and equipment	16,753
Acquisition of IES (1)	--
Acquisition of MDT (2)	--
Repayment of promissory note related to acquisition of subsidiary	(750,000)
Purchase of intangible assets and inventory	(196,331)
Increase in restricted cash	(72,840)
Net cash used in discontinued operations (purchase of property and equipment)	--

Net cash used in investing activities	(1,797,440)

Cash flows from financing activities:	
Proceeds from issuance of shares, net	(6,900)
Proceeds from exercise of options to employees and consultants	440,914
Proceeds from exercise of warrants	3,296,254
Proceeds from the sale of convertible debentures, net	13,708,662
Payment of interest and principal on notes receivable from shareholders	--
Profit distribution to minority	--
Increase (decrease) in short term bank credit	(74,158)
Payment on capital lease obligation	(4,427)

Net cash provided by financing activities	17,360,345

Increase (decrease) in cash and cash equivalents	12,237,161
Cash erosion due to exchange rate differences	(9,562)
Cash and cash equivalents at the beginning of the year	1,457,526

Cash and cash equivalents at the end of the year	\$ 13,685,125
	=====
Supplementary information on non-cash transactions:	
Purchase of property and equipment against trade payables	\$ --
	=====
Purchase of treasury stock in respect of notes receivable from shareholders	\$ --
	=====
Retirement of shares issued under notes receivables	\$ --
	=====
Issuance of shares to consultants in respect of prepaid interest expenses	\$ --
	=====
Exercise of options against notes receivable	\$ --
	=====
Purchase of intangible assets against note receivable	\$ 300,000
	=====
Increase of investment in subsidiary against issuance of shares of common stock	\$ 123,480
	=====
Conversion of promissory note to shares of common stock	\$ 450,000
	=====
Conversion of convertible debenture to shares of common stock	\$ 6,125,000
	=====
Benefit due to convertible debentures and warrants	\$ 10,853,043

Edgar Filing: AROTECH CORP - Form 10-K/A

Supplemental disclosure of cash flows activities: Cash paid during the year for:
Interest

=====
\$ 39,412
=====

* Restated (see Note 1.b.).

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

F - 10

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (Cont.)

In U.S. dollars

- (1) In July 2002, the Company acquired substantially all of the assets of I.E.S. Electronics Industries U.S.A., Inc. ("IES"). 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	\$ 1,233,000
Property and equipment, net	396,776
Capital lease obligation	(15,526)
Technology	1,515,000
Existing contracts	46,000
Covenants not to compete	99,000
In process research and development	26,000
Customer list	527,000
Trademarks	439,000
Goodwill	4,032,726

	8,298,976
Issuance of shares	(3,653,929)
Issuance of promissory note	(1,686,964)

	\$ 2,958,083
	=====

- (2) In July 2002, the Company acquired 51% of the outstanding ordinary shares of MDT Protective Industries Ltd. ("MDT"). The fair value of the assets acquired and liabilities assumed was as follows:

Working capital, excluding cash and cash and cash equivalents	\$ 350,085
Property, and equipment, net	139,623
Minority rights	(300,043)
Technology	280,000
Customer base	285,000
Goodwill	886,255

	1,640,920
Issuance of shares	(439,077)

	\$ 1,201,843
	=====

Edgar Filing: AROTECH CORP - Form 10-K/A

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

F - 11

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL

a. Arotech Corporation, f/k/a Electric Fuel Corporation ("Arotech" or the "Company") and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles, and in the design, development and commercialization of its proprietary zinc-air battery technology for electric vehicles and defense applications. The Company is primarily operating through Electric Fuel Ltd. ("EFL") a wholly-owned Israeli subsidiary; IES Interactive Training, Inc. ("IES"), a wholly-owned U.S. subsidiary; Arocon Security Corporation, a wholly-owned U.S. subsidiary; Electric Fuel Battery Corporation, a wholly-owned U.S. subsidiary; MDT Protective Industries ("MDT"), an Israeli subsidiary in which the Company has a 75.5% interest; and MDT Armor Corporation, a U.S. subsidiary in which the Company has an 88% interest. The Company's production and research and development operations are primarily located in Israel and in the United States.

b. Restatement of previously-issued financial statements:

During management's review of the Company's interim financial statements for the period ended September 30, 2004 the Company, after discussion with and based on a new and revised review of accounting treatment by its independent auditors, conducted a comprehensive review of the re-pricing of warrants and grant of new warrants to certain of its investors and others during 2003 and 2004. As a result of that review, the Company, upon recommendation of management and with the approval of the Audit Committee of the Board of Directors after discussion with the Company's independent auditors, reconsidered the accounting related to these transactions and reclassified certain expenses as a deemed dividend, a non-cash item, instead of as general and administrative expenses due to the recognition of these transactions as capital transactions that should not be expensed. These restatements do not affect the balance sheet, the shareholders' equity or the cash flow statements. In addition and as a result of the remeasurement described above, the Company has reviewed assumptions used in the calculation of fair value of all warrants granted during the year 2003. As a result of this comprehensive review, the Company has decreased its general and administrative expenses in the amount of \$150,000, related to errors found in the valuation of warrants granted in a litigation settlement.

In addition, during management's review of the Company's interim financial statements for the period ended September 30, 2004, the Company also reviewed its calculation of amortization of debt discount attributable to the beneficial conversion feature associated with the convertible debentures. As a result of this review, the Company found errors which increased its financial expenses in the amount of \$568,000 for the year ended December 31, 2003. The errors were related to the amortization of debt discount attributable to the warrants and their related convertible debentures, whereby the Company understated the amount of amortization for the year ended December 31, 2003 attributable to certain of

Edgar Filing: AROTECH CORP - Form 10-K/A

the convertible debentures. See Note 16.

Similar errors were also noted in the Company's interim financial statements in the three-month period ended June 30, 2003, the nine-month period ended September 30, 2003, and the three- and six-month periods ended March 31 and June 30, 2004.

F - 12

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

The impacts of these restatements with respect to the year ended December 31, 2003 are summarized below:

Statement of Operations Data:

	For the Year ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
General and administrative expenses	\$6,196,779	\$ (338,903)	\$5,857,876
Operating loss	5,408,932	(338,903)	5,070,029
Financial expenses, net	3,470,459	568,250	4,038,709
Loss from continuing operations	9,118,684	229,347	9,348,031
Net loss	9,008,274	229,347	9,237,621
Deemed dividend to certain stockholders of common stock	--	350,000	350,000
Net loss attributable to common stockholders	\$9,008,274	\$ 579,347	\$9,587,621
Basic and diluted net loss per share from continuing operations	\$ 0.23	\$ 0.01	\$ 0.24
Basic and diluted net loss per share	\$ 0.23	\$ 0.02	\$ 0.25

Balance sheet data:

	As of December 31, 2003		
	Previously Reported	Adjustment	As Restated

Other accounts payable

Edgar Filing: AROTECH CORP - Form 10-K/A

and accrued expenses	\$ 4,321,347	\$ (150,000)	\$ 4,171,347
Total current liabilities	6,859,752	(150,000)	6,709,752
Convertible debenture	881,944	568,250	1,450,194
Total long term liabilities	4,066,579	568,250	4,634,829
Additional paid in capital	135,891,316	(188,903)	135,702,413
Accumulated deficit	(109,681,893)	(229,347)	(109,911,240)
Total shareholders' equity	22,044,127	(418,250)	21,625,877

F - 13

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

Cash flow data:

	For the Year ended December 31, 2003		
	Previously Reported	Adjustment	As Restated
	-----	-----	-----
Net loss	\$9,008,274	\$ 229,347	\$9,237,621
Stock based compensation related to repricing of warrants granted to investors and the grant of new warrants	388,403	(188,903)	199,500
Increase in other accounts payable and accrued expenses	1,827,668	(150,000)	1,677,668
Amortization of compensation related to beneficial conversion feature and warrants issued to holders of convertible debentures	3,359,987	568,250	3,928,237

c. Acquisition of IES:

In August 2, 2002, the Company entered into an asset purchase agreement among I.E.S. Electronics Industries U.S.A., Inc. ("IES"), its direct and certain of its indirect shareholders, and its wholly-owned Israeli subsidiary, EFL, pursuant to the terms of which it acquired substantially all the assets, subject to substantially all the liabilities, of IES, a developer, manufacturer and marketer of advanced hi-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel. The Company intends to continue to use the assets purchased in the conduct of the business formerly conducted by IES (the "Business"). The acquisition has been accounted under the purchase method of accounting. Accordingly, all assets and liabilities were acquired as at the values on such date, and the Company consolidated IES's results with its own commencing at such date.

The assets purchased consisted of the current assets, property and equipment, and other intangible assets used by IES in the conduct of the Business. The consideration for the assets and liabilities purchased consisted of (i) cash and

Edgar Filing: AROTECH CORP - Form 10-K/A

promissory notes in an aggregate amount of \$4,800,000 (\$3,000,000 in cash and \$1,800,000 in promissory notes, which was recorded at its fair value in the amount of \$1,686,964) (see Note 9), and (ii) the issuance, with registration rights, of a total of 3,250,000 shares of our common stock, \$.01 par value per share, having a value of approximately \$3,653,929, which shares are the subject of a voting agreement on the part of IES and certain of its affiliated companies. The value of 3,250,000 shares issued was determined based on the average market price of Arotech's Common stock over the period including two days before and after the terms of the acquisition were agreed to and announced. The total consideration of \$8,354,893 (including \$14,000 of transaction costs) was determined based upon arm's-length negotiations between the Company and IES and IES's shareholders.

F - 14

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

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

Tangible assets acquired	\$ 2,856,951
Intangible assets	
Technology (four year useful life)	1,515,000
Existing contracts (one year useful life)	46,000
Covenants not to compete (five year useful life)	99,000
In process research and development	26,000
Customer list (seven year useful life)	527,000
Trademarks (indefinite useful life)	439,000
Goodwill	4,032,726
Liabilities assumed	(1,186,784)
Total consideration	\$ 8,354,893 =====

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

The value assigned to the tangible, intangibles assets and liabilities was determined as follows:

1. To determine the value of the Company's net current assets, property and equipment, and net liabilities; the Cost Approach was used, which requires that the assets and liabilities in question be restated to their market values. Per estimation made by the independent appraisal the book values for the current assets and liabilities were reasonable proxies for their market values.

Edgar Filing: AROTECH CORP - Form 10-K/A

2. The amount of the excess cost attributable to technology of Range 2000, 3000 and A2Z Systems is \$1,515,000 and was determined using the Income Approach.
3. The value assigned to purchased in-process technology relates to two projects "Black Box" and A2Z trainer. The estimated fair value of the acquired in-process research and development platforms that had not yet reached technological feasibility and had no alternative future use amounted to \$26,000. Technological feasibility or commercial viability of these projects was established at the acquisition date. These products were considered to have no alternative future use other than the technological indications for which they were in development. Accordingly, these amounts were immediately expensed in the consolidated statement of operations on the acquisition date in accordance with FASB Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method." The estimated fair values of these platforms were determined using discounted cash flow models. Projects were estimated to be 4% complete; estimated costs to completion of these platforms were approximately \$200,000 and \$25,000, respectively, and discount rate of 25% was used.

F - 15

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

4. The value assigned to the customer list is amounted to \$527,000. Management states that its customers have generally been very loyal to IES's products; most present customers are expected to purchase add-ons or up-grades to their IES simulator systems in the future, and some will purchase additional warranties for the systems they possess. Independent appraisal has therefore valued the Company's customer list using the Income Approach.
5. The value assigned to the trademarks amounted to \$439,000 and was determined based on the Cost Approach. In doing so, it is assumed that historical expenditures for advertising are a reasonable proxy for the future benefits expected from the Trademarks and Trade names.
6. Value of IES's Covenant Not to Compete (CNC) was valued at the amount of \$99,000. One of IES's intangible assets is its covenant not to compete. Asset Purchase Agreement precludes the former parent company, and its principals and key employees from competing with IES for five years from the Valuation Date. According to management, among the individuals covered by the CNC are the original developers of the Range 2000 and A2Z systems. Estimated CNC's value was determined using the Income Approach. The estimated value of the CNC is the sum of the present value of the cash flows that would be lost if the CNC was not in place. Specifically, the value of the CNC is calculated as the difference between the projected cash flows if the former parent company or its principals were to start competing immediately and the projected cash flows if those parties start competing after five years, when the CNC expires.

Edgar Filing: AROTECH CORP - Form 10-K/A

In September 2003, the Company's IES subsidiary purchased selected assets of Bristlecone Corporation. The assets purchased consisted of inventories, customer lists, and certain other assets (including intangible assets such as intellectual property and customer lists), including the name "Bristlecone Training Products" and the patents for the Heads Up Display (HUD) and a remote trigger device, used by Bristlecone in connection with its designing and manufacturing firearms training devices, for a total consideration of \$183,688 in cash and \$300,000 in promissory notes, payable in four equal semi-annual payments of \$75,000 each, to become due and payable on March 1, 2004, August 31, 2004, February 28, 2005 and August 31, 2005. The acquired patents are used in the IES's Range FDU (firearm diagnostics unit).

The purchase consideration was estimated as follows:

F - 16

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

	U.S. Dollars

Cash consideration	\$183,688
Present value of promissory notes	289,333
Transaction expenses	12,643

Total consideration	\$485,664
	=====

Based upon a valuation of tangible and intangible assets acquired, the Company has allocated the total cost of the acquisition of Bristlecone's assets as follows:

	U.S. Dollars

Tangible assets acquired	\$ 33,668
Intangible assets	
Technology and patents	436,746
Customer list	15,250

Total consideration	\$485,664
	=====

The Company believes that the acquisition of Bristlecone is not material to its business.

d. Acquisition of MDT:

On July 1, 2002, the Company entered into a stock purchase agreement with all of the shareholders of M.D.T. Protective Industries Ltd. ("MDT"), pursuant to the terms of which the Company purchased 51% of the issued and outstanding shares of MDT, a privately-held Israeli company that specializes in using sophisticated lightweight materials and advanced engineering processes to armor vehicles. The Company also entered into certain other ancillary agreements with MDT and its shareholders and other affiliated companies. The Acquisition was accounted under the purchase method accounting and results of MDT's operations have been included in the consolidated financial statements since that date. The total

Edgar Filing: AROTECH CORP - Form 10-K/A

consideration of \$1,767,877 for the shares purchased consisted of (i) cash in the aggregate amount of 5,814,000 New Israeli Shekels (\$1,231,780), and (ii) the issuance, with registration rights, of an aggregate of 390,638 shares of our common stock, \$0.01 par value per share, having a value of approximately \$439,077. The value of 390,638 shares issued was determined based on the average market price of Arotech's Common stock over the period including two days before and after the terms of the acquisition were agreed to and announced.

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

Tangible assets acquired	\$ 1,337,048
Intangible assets	
Technology (five year weighted average useful life)	280,000
Customer base (five year weighted average useful life)	285,000
Goodwill	886,255
Liabilities assumed	(1,020,426)

Total consideration	\$ 1,767,877 =====

F - 17

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

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

The value assigned to the tangible, intangibles assets and liabilities was determined as follows:

1. To determine the value of the Company's net current assets, net property, and equipment and net liabilities; the Cost Approach was used, which requires that the assets and liabilities in question be restated to their market values. Per estimation made by the independent appraisal the book values for the current assets and liabilities were reasonable proxies for their market values.
2. The amount of the excess cost attributable to technology of optimal bulletproofing material and power mechanism for bulletproofed windows is \$280,000 and was determined using the Income Approach.
3. The value assigned to the customer base is amounted to \$285,000. Independent appraisal has valued the Company's customer base using the Income Approach. The valuation of the customers' base derives mostly from relations with customers with no contracts. Most of the customers of MDT are from defense sector and usually have

Edgar Filing: AROTECH CORP - Form 10-K/A

longstanding relationships and tend to reorder from the Company.

In September 2003, the Company increased its holdings in both of its vehicle armoring subsidiaries. The Company now holds 88% of MDT Armor Corporation (compared to 76% before this transaction) and 75.5% of MDT Protective Industries Ltd. (compared to 51% before this transaction). The Company acquired the additional stake in MDT from AGA Means of Protection and Commerce Ltd. in exchange for the issuance to AGA of 126,000 shares of its common stock, valued at \$0.98 per share based on the closing price of the Company's common stock on the closing date of September 4, 2003, or a total of \$123,480. Of this amount, a total of \$75,941 was allocated to intangible assets. The Company did not obtain a valuation due to the immaterial nature of this acquisition.

e. Pro forma results:

The following unaudited proforma information does not purport to represent what the Company's results of operations would have been had the acquisitions occurred on January 1, 2001 and 2002, nor does it purport to represent the results of operations of the Company for any future period.

F - 18

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

	Year ended December 31,	
	2002	2001
Revenues	\$12,997,289 =====	\$ 12,369,749 =====
Net loss from continuing operations	\$ (6,103,771) =====	\$ (5,757,675) =====
Basic and diluted net loss per share for continuing operations	\$ (0.18) =====	\$ (0.21) =====
Weighted average number of shares of common stock in computation of basic and diluted net loss per share	34,495,185 =====	27,840,822 =====

The amount of the excess cost attributable to in-process research and development of IES and MDT in the amount of \$26,000 has not been included in the pro forma information, as it does not represent a continuing expense.

f. Discontinued operations:

In September 2002, the Company committed to a plan to discontinue the operations of its retail sales of consumer battery products. The Company ceased the operation and disposed of all assets related to this segment by an abandonment.

Edgar Filing: AROTECH CORP - Form 10-K/A

The operations and cash flows of consumer battery business have been eliminated from the operations of the entity as a result of the disposal transactions. The Company has no intent of continuing its activity in the consumer battery business. The Company's plan of discontinuance involved (i) termination of all employees whose time was substantially devoted to the consumer battery line and who could not be used elsewhere in the Company's operations, including payment of all statutory and contractual severance sums, by the end of the fourth quarter of 2002, and (ii) disposal of the raw materials, equipment and inventory used exclusively in the consumer battery business, since the Company has no reasonable expectation of being able to sell such raw materials, equipment or inventory for any sum substantially greater than the cost of disposal or shipping, by the end of the first quarter of 2003. The Company had previously reported its consumer battery business as a separate segment (Consumer Batteries) as called for by Statement of Financial Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS No. 131").

The results of operations including revenue, operating expenses, other income and expense of the retail sales of consumer battery products business unit for 2002 and 2001 have been reclassified in the accompanying statements of operations as a discontinued operation. The Company's balance sheets at December 31, 2002 and 2001 reflect the net liabilities of the retail sales of consumer battery products business as net liabilities and net assets of discontinued operation within current liabilities and current assets.

At December 31, 2002, the estimated net losses associated with the disposition of the retail sales of consumer battery products business were approximately \$13,566,206 for 2002. These losses included approximately \$6,508,222 in losses from operations for the period from January 1, 2002 through the measurement date of December 31, 2002 and \$7,057,684, reflecting a write-down of inventory and net property and equipment of the retail sales of consumer battery products business, as follows:

F - 19

AROTECH CORPORATION AND ITS SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

 In U.S. dollars

NOTE 1:- GENERAL (Cont.)

	December 31, 2002

Write-off of inventories	\$2,611,000
Impairment of property and equipment	4,446,684

	\$7,057,684
	=====

As a result of the discontinuance of consumer battery segment, the Company ceased to use property and equipment related to this segment. In accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") such assets was considered to be impaired, the impairment to be recognized was measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Obligations to employees for severance and other benefits resulting from the discontinuation have been reflected in the financial statements on an accrual

Edgar Filing: AROTECH CORP - Form 10-K/A

basis.

Summary operating results from the discontinued operation for the years ended December 31, 2003, 2002 and 2001 are as follows:

	Year Ended December 31,		
	2003	2002	2001
Revenues	\$ 117,267	\$ 1,100,442	\$ 1,939,256
Cost of sales (1)	--	(5,293,120)	(5,060,966)
Gross profit (loss)	117,267	(4,192,678)	(3,121,710)
Operating expenses, net	6,857	4,926,844	10,139,289
Impairment of fixed assets	--	4,446,684	--
Operating profit (loss)	\$ 110,410	\$ (13,566,206)	\$ (13,260,999)

(1) Including write-off of inventory in the amount of \$0, \$2,611,000 and \$441,000 for the years ended December 31, 2003, 2002 and 2001.

F - 20

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

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

The majority of financial transactions of MDT is in New Israel Shekel ("NIS")

Edgar Filing: AROTECH CORP - Form 10-K/A

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

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence and for market prices lower than cost. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are made to write inventory down to its market value. In 2003, the Company wrote off \$96,350 of obsolete inventory, which has been included in the cost of revenues.

F - 21

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Cost is determined as follows:

Raw and packaging materials - by the average cost method.

Work in progress - represents the cost of manufacturing with the addition of allocable indirect manufacturing cost.

Finished products - on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

f. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants (no investment grants were received during 2003, 2002 and 2001).

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

⌘

Computers and related equipment	33
Motor vehicles	15
Office furniture and equipment	6 - 10
Machinery, equipment and installation	10 - 25 (mainly 10)
Leasehold improvements	Over the term of the lease

g. Goodwill:

Goodwill represents the excess of cost over the fair value of the net assets of businesses acquired. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No, 142") goodwill acquired in a business combination on or after July 1, 2001, is not amortized.

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. Fair value is determined using discounted cash flows, market multiples and market capitalization. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units.

h. Other intangible assets:

Intangible assets acquired in a business combination that are subject to amortization are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142. Intangible assets are amortized over their useful life (See Note 1b. and c).

AROTECH CORPORATION AND ITS SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

i. Impairment of indefinite-lived intangible asset

The acquired IES trademark is deemed to have an indefinite useful life because it is expected to contribute to cash flows indefinitely. Therefore, the trademark will not be amortized until its useful life is no longer indefinite. The trademark is tested annually for impairment in accordance FAS 142.

j. Impairment of long-lived assets:

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

Edgar Filing: AROTECH CORP - Form 10-K/A

undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2003 no impairment losses have been identified.

k. Revenue recognition:

The Company generates revenues primarily from sales of multimedia and interactive digital training systems and use-of-force simulators specifically targeted for law enforcement and firearms training and from service contracts related to such sales (through IES), from providing lightweight armoring services of vehicles (through MDT), and from sale of zinc-air battery products for defense applications. To a lesser extent, revenues are generated from development services and long-term arrangements subcontracted by the U.S. Government.

Revenues from products, training and simulation systems are recognized in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" ("SAB No. 104") when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probable, and no further obligation remains.

The Company does not grant a right of return to its customers.

Revenues from long-term agreements, subcontracted by the U.S. government, are recorded on a cost-sharing basis, when services are rendered and products delivered, as prescribed in the related agreements. Provisions for estimated losses are recognized in the period in which the likelihood of such losses is determined. As of December 31, 2003, no such estimated losses were identified.

Deferred warranty revenues includes unearned amounts received from customers, but not recognized as revenues.

Revenues from development services are recognized based on Statement of Position No. 81-1 "Accounting for Performance of Construction - Type and Certain Production - Type Contracts" ("SOP 81-1"), using contract accounting on a percentage of completion method, based on completion of agreed-upon milestones and in accordance with the "Output Method" or based on the time and material basis. Provisions for estimated losses on uncompleted contracts are recognized in the period in which the likelihood of such losses is determined. As of December 31, 2003, no such estimated losses were identified.

F - 23

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues from lightweight armoring services of vehicles are recorded when services are rendered and vehicle is delivered and no additional obligations exists.

Revenues from products not delivered upon customers' request due to lack of storage space at the customers' facilities during the integration are recognized when the criteria of Staff Accounting Bulletin No. 104 ("SAB No. 104") for bill-and-hold transactions are met.

l. Research and development cost:

Research and development costs, net of grants received, are charged to the statements of operations as incurred.

Significant software development costs incurred by the Company's subsidiaries between completion of the working model and the point at which the product is ready for general release, are capitalized.

Capitalized software costs are amortized by using the straight-line method over the estimated useful life of the product (three to five years). The Company assesses the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through future gross revenues from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2003.

m. Royalty-bearing grants:

Royalty-bearing grants from the Office of the Chief Scientist ("OCS") of the Israeli Ministry of Industry and Trade and from the Israel-U.S. Bi-national Industrial Research and Development Foundation ("BIRD-F") for funding approved research and development projects are recognized at the time the Company is entitled to such grants on the basis of the costs incurred, and included as a deduction of research and development costs.

n. Income taxes:

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

o. Concentrations of credit risk:

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

Edgar Filing: AROTECH CORP - Form 10-K/A

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

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

p. Basic and diluted net loss per share:

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

All outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share was 22,194,211 and 4,394,803 and 3,170,334 for the years ended December 31, 2003, 2002 and 2001, respectively.

q. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB No. 25") and Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized. Under Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), pro-forma information regarding net income and net income 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 Company applies SFAS No. 123 and Emerging Issue Task Force No. 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

The fair value for the options to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 2.54%, 3.5% and 3.5-4.5% for 2003, 2002 and 2001, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the common stock of 0.67 for 2003, 0.64 for 2002 and 0.82 for 2001; and a weighted-average expected life of the option of 5 years for 2003, 2002 and 2001.

Edgar Filing: AROTECH CORP - Form 10-K/A

AROTECH CORPORATION AND ITS SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

 In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The following table illustrates the effect on net income and earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS No. 123 on its stock-based employee compensation:

	Year ended December 31,		
	2003*	2002	
Net loss as reported	\$ (9,237,621)	\$ (18,504,358)	\$ (1)
Add: Stock-based compensation expenses included in reported net loss	8,286	6,000	
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(1,237,558)	(2,072,903)	(
	-----	-----	-----
	\$ (10,466,893)	\$ (20,571,261)	\$ 2
	=====	=====	=====
Loss per share:			
Basic and diluted, as reported	\$ (0.25)	\$ (0.57)	\$
	=====	=====	=====
Diluted, pro forma	\$ (0.27)	\$ (0.64)	\$
	=====	=====	=====

 * Restated (see Note 1.b.).

r. Fair value of financial instruments:

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

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

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

s. Severance pay:

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

Edgar Filing: AROTECH CORP - Form 10-K/A

In addition and according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. The Company has made a provision for this special severance pay in accordance with Statement of Financial Accounting Standard No. 106, "Employer's Accounting for Post Retirement Benefits Other than Pensions" ("SFAS No. 106"). As of December 31, 2003 and 2002, the accumulated severance pay in that regard amounted to \$ 1,699,260 and \$1,630,366, respectively.

F - 26

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

Severance expenses for the year ended December 31, 2003 amounted to \$ 219,857 as compared to severance income and expenses for the years ended December 31, 2002 and 2001, which amounted to \$338,574 and \$653,885, respectively.

t. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2003, 2002 and 2001 was approximately \$34,732, \$294,599 and \$1,676,280 respectively.

NOTE 3:- RESTRICTED COLLATERAL DEPOSIT AND OTHER RESTRICTED CASH

The restricted collateral deposit is invested in a \$706,180 certificate of deposit that is used to secure certain real property lease arrangements, and a currency hedging arrangement to protect the Company against change in the euro versus the dollar in connection with IES's contract with the German police, which is denominated in euros; a portion was also on deposit with an arbitrator in connection with the Company's litigation with IES Electronic Industries, Ltd.

	December 31, 2003

IES Deposit	\$ 450,000
Forward Deal	205,489
Property Lease	41,412
Other	9,279

	\$ 706,180
	=====

NOTE 4:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	-----	-----
	2003	2002
	-----	-----

Edgar Filing: AROTECH CORP - Form 10-K/A

Government authorities	\$ 65,402	\$ 348,660
Employees	246,004	23,959
Prepaid expenses	551,010	591,008
Other	324,955	68,684
	-----	-----
	\$1,187,371	\$1,032,311
	=====	=====

F - 27

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 5:- INVENTORIES

	December 31,	
	2003	2002
	-----	-----
Raw and packaging materials	\$ 657,677	\$ 893,666
Work in progress	634,221	296,692
Finished products	622,850	521,121
	-----	-----
	\$ 1,914,748	\$ 1,711,479
	=====	=====

NOTE 6:- PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2003	2002
	-----	-----
Cost:		
Computers and related equipment	\$1,015,836	\$ 815,759
Motor vehicles	288,852	335,286
Office furniture and equipment	402,726	519,092
Machinery, equipment and installations	4,866,904	4,715,182
Leasehold improvements	882,047	442,482
Demo inventory	150,996	154,689
	-----	-----
	7,607,361	6,982,490
	-----	-----
Accumulated depreciation:		
Computers and related equipment	753,593	669,258
Motor vehicles	95,434	39,281
Office furniture and equipment	173,301	255,829
Machinery, equipment and installations	3,637,111	3,106,389
Leasehold improvements	655,181	356,484
	-----	-----
	5,314,620	4,427,241

Edgar Filing: AROTECH CORP - Form 10-K/A

	-----	-----
Depreciated cost	\$2,292,741	\$2,555,249
	=====	=====

b. Depreciation expense amounted to \$730,159, \$473,739 and \$530,013, for the years ended December 31, 2003, 2002 and 2001, respectively.

As for liens, see Note 10.d.

F - 28

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 7:- OTHER INTANGIBLE ASSETS, NET

a.

	Year ended December 31,	
	2003	2002
	-----	-----
Cost:		
Technology	\$ 2,231,746	\$ 1,795,000
Capitalized research and development	209,615	--
Existing contracts	46,000	46,000
Covenants not to compete	99,000	99,000
Customer list	827,250	812,000
	-----	-----
	3,413,611	2,752,000
Exchange differences	25,438	--
Less - accumulated amortization	(1,502,854)	623,543
	-----	-----
Amortized cost	1,936,195	2,128,457
Trademarks	439,000	439,000
	-----	-----
	\$ 2,375,195	\$ 2,567,457
	=====	=====

b. Amortization expenses amounted to \$879,311 for the year ended December 31, 2003.

c. Estimated amortization expenses for the years ended:

	Year ended December 31,	

2004	\$	552,443
2005		541,466
2006		366,421
2007		244,734

Edgar Filing: AROTECH CORP - Form 10-K/A

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

a. Royalty commitments:

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

Royalties paid or accrued for the years ended December 31, 2003, 2002 and 2001, to the OCS amounted to \$435, \$32,801 and \$75,791, respectively.

As of December 31, 2003, the total contingent liability to the OCS was approximately \$10,057,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

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

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

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2003.

As of December 31, 2003, the total contingent liability to pay BIRD-F (150%) was approximately \$772,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

F - 30

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

b. Lease commitments:

The Company and its subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2005.

Edgar Filing: AROTECH CORP - Form 10-K/A

The minimum rental payments under non-cancelable operating leases are as follows:

Year ended December 31,	

2004	\$ 393,512
2005	197,266

	\$ 590,778
	=====

Total rent expenses for the years ended December 31, 2003, 2002 and 2001, were approximately \$484,361, \$629,101 and \$456,701, respectively.

c. Guarantees:

The Company obtained bank guarantees in the amount of \$51,082 in connection with (i) a lease agreement of one of the Company's subsidiaries, (ii) a sales obligation to a customer of one of the Company's subsidiaries, and (iii) obligations of one of the Company's subsidiaries to the Israeli customs authorities.

d. Liens:

As security for compliance with the terms related to the investment grants from the state of Israel, EFL has registered floating liens on all of its assets, in favor of the State of Israel.

The Company has granted to the holders of its 8% secured convertible debentures a first position security interest in (i) the shares of MDT Armor Corporation, (ii) the assets of its IES Interactive Training, Inc. subsidiary, (iii) the shares of all of its subsidiaries, and (iv) any shares that the Company acquires in future Acquisitions (as defined in the securities purchase agreement).

EFL has granted to its former CEO a security interest in certain of its property located in Beit Shemesh, Israel, to secure sums due to him pursuant to the terms of the settlement agreement with him.

F - 31

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY

a. Shareholders' rights:

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

b. Issuance of common stock to investors:

1. In May 2001, the Company issued a total of 4,045,454 shares of its common stock to a group of institutional investors at a price of \$2.75 per share, or a total purchase price of \$11,125,000. (See also Note 11.f.1 and 11.f.2.)

Edgar Filing: AROTECH CORP - Form 10-K/A

2. On November 21, 2001, the Company issued a total of 1,503,759 shares of its common stock at a purchase price of \$1.33 per share, or a total purchase price of \$2,000,000, to a single institutional investor.
 3. On December 5, 2001, the Company issued a total of 1,190,476 shares of its common stock at a purchase price of \$1.68 per share, or a total purchase price of \$2,000,000, to a single institutional investor.
 4. On January 18, 2002, the Company issued a total of 441,176 shares of its common stock at a purchase price of \$1.70 per share, or a total purchase price of \$750,000, to an investor (see also Note 11.f.3).
 5. On January 24, 2002, the Company issued a total of 1,600,000 shares of its common stock at a purchase price of \$1.55 per share, or a total purchase price of \$2,480,000, to a group of investors.
- c. Issuance of common stock to service providers and employees:
1. On June 17, 2001 the Company issued a consultant a total of 8,550 shares of its common stock in compensation for services rendered by such consultant for the Company for preparation of certain video point-of-purchase and sales demonstration materials. At the issuance date the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$15,488 in accordance with EITF 96-18. In accordance with EITF 00-18, the Company recorded this compensation expense as marketing expenses in the amount of \$15,488.
 2. On September 17, 2001 the Company issued to selling and marketing consultants a total of 337,571 shares of its common stock in compensation for distribution services rendered by such consultant. At the issuance date the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$524,889 in accordance with EITF 96-18 and in accordance with EITF 00-18. The Company recorded this compensation expense as marketing expenses in the amount of \$524,889.
 3. On February 15, 2002 and September 10, 2002, the Company issued 318,468 and 50,000 shares, respectively, of common stock at par consideration to a consultant for providing business development and marketing services in the United Kingdom. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$394,698 and \$63,000, respectively, in accordance with EITF 96-18. In accordance with EITF 00-18, the Company recorded this compensation expense of \$394,698 and \$63,000, respectively, during the year 2002 and included this amount in marketing expenses.

F - 32

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

Edgar Filing: AROTECH CORP - Form 10-K/A

4. On September 10, 2002, the Company issued an aggregate of 13,000 shares of common stock at par consideration to two of its employees as stock bonuses. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by fair market price at the issuance date in accordance with APB No. 25. In accordance with APB No. 25, the Company recorded this compensation expense of \$13,000 during the year 2002 and included this amount in general and administrative expenses.

5. In July 2003, the Company issued 215,294 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$154,331 in accordance with EITF 96-18. In accordance with EITF 00-18, the Company recorded this compensation expense of \$154,331 during the year 2003 and included this amount in marketing expenses.

6. In November 2003, the Company issued 8,306 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by fair market price at the issuance date and by the value of the services provided and amounted to \$7,616 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of \$7,616 during the year 2003 and included this amount in marketing expenses.

d. Issuance of shares to lenders

As part of the securities purchase agreement on December 31, 2002 (see Note 16.a), the Company issued 387,301 shares at par as consideration to lenders for the first nine months of interest expenses. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by fair market price at the issuance date and by the value of the interest and amounted to \$236,250 in accordance with APB 14. During 2003 the company recorded this amount as financial expenses.

e. Issuance of notes receivable:

1. As part of its purchase of the assets of IES Interactive Training, Inc. (see Note 1.c.), the Company issued a \$450,000 convertible promissory note (see Note 8). This note was converted into an aggregate of 563,971 shares of common stock in August 2003.

f. Warrants:

1. As part of an investment agreement in November 2000, the Company issued warrants to purchase an additional 1,000,000 shares of common stock to the investor, with exercise prices of \$11.31 for 333,333 of these warrants and \$12.56 per share for 666,667 of these warrants. In addition, the Company issued warrants to purchase 150,000 shares of common stock, with exercise prices of \$9.63 for 50,000 of these warrants and \$12.56 per share for 100,000 of these warrants to an investment banker involved in this agreement. Out of these warrants issued to the investor, 666,667 warrants expire on November 17, 2005 and 333,333 warrants were to expire on August 17, 2001.

Edgar Filing: AROTECH CORP - Form 10-K/A

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

As part of the transaction in May 2001 (see Note 11.b.1), the Company repriced these warrants in the following manner:

- >> Of the 1,000,000 warrants granted to the investor, the exercise price of 666,667 warrants was reduced from \$12.56 to \$3.50 and of 333,333 warrants was reduced from \$11.31 to \$2.52. In addition, the 333,333 warrants that were to expire on August 17, 2001, were immediately exercised for a total consideration of \$840,000.
- >> Moreover, the Company issued to this investor an additional warrant to purchase 250,000 shares of common stock at an exercise price of \$3.08 per share, to expire on May 3, 2006.
- >> Of the 150,000 warrants granted to the investment banker the exercise price of 100,000 warrants was reduced from \$12.56 to \$3.08 and of 50,000 warrants was reduced from \$9.63 to \$3.08. In addition, the 50,000 warrants that were to expire on August 17, 2001 were extended to November 17, 2005.

As a result of the aforesaid modifications, including the repricing of the warrants to the investors and to the investment banker and the additional grant of warrants to the investor, the Company has recorded a deemed dividend in the amount of \$1,196,667, to reflect the additional benefit created for these certain investors. The fair value of the repriced warrants was calculated as a difference measured between (1) the fair value of the modified warrant determined in accordance with the provisions of SFAS No. 123, and (2) the value of the old warrant immediately before its terms are modified, determined based on the shorter of (a) its remaining expected life or (b) the expected life of the modified option. The deemed dividend increased the loss applicable to common stockholders in the calculation of basic and diluted net loss per share for the year ended December 31, 2001, without any effect on total shareholder's equity.

2. As part of the investment agreement in May 2001 (see Note 11.b.1), the Company issued to the investors a total of 2,696,971 warrants (the "May 2001 Warrants") to purchase shares of common stock at a price of \$3.22 per share; these warrants are exercisable by the holder at any time after November 8, 2001 and will expire on May 8, 2006. The Company also issued to a financial consultant that provided investment banking services concurrently with this transaction a total of 125,000 warrants to purchase shares of common stock at a price of \$3.22 per share; these warrants are exercisable by the holder at any time and will expire on June 12, 2006. In addition the Company paid approximately \$562,000 in cash, which was recorded as deduction from additional paid in capital.

In June and July 2003, the Company adjusted the purchase price of 1,357,577 of the May 2001 Warrants to \$0.82 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 905,052 shares of common stock at a purchase price of \$1.45 per share (the "June 2003 Warrants"). The June 2003 Warrants were originally exercisable at any time from and after December 31, 2003 to June 30, 2008; however, in September 2003, the exercise period of 638,385 of these June 2003 Warrants was adjusted to make them exercisable at any time from and after December 31, 2004 to June 30, 2009. As a result the company recorded during 2003 a deemed dividend in the amount of \$267,026. See also Note 1.b.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

In addition, with respect to an additional 387,879 May 2001 Warrants, in December 2003 the Company adjusted the purchase price to \$1.60 per share in exchange for immediate exercise of these warrants, and issued to the holders of these exercised warrants new warrants to purchase a total of 193,940 shares of common stock at a purchase price of \$2.25 per share. As a result the company recorded during 2003 a deemed dividend in the amount of \$82,974. See also Note 1.b.

Additionally, in October 2003 the Company granted to three of these investors additional new warrants to purchase a total of 150,000 shares of common stock at a purchase price of \$1.20 per share. As a result the company recorded during 2003 an expense of \$199,500 and included this amount in general and administrative expenses.

3. As part of the investment agreement in January 2002 (see Note 11.b.4), the Company, in January 2002, issued to a financial consultant that provided investment banking services concurrently with this transaction a warrants to acquire (i) 150,000 shares of common stock at an exercise price of \$1.68 per share, and (ii) 119,000 shares of common stock at an exercise price of \$2.25 per share; these warrants are exercisable by the holder at any time and will expire on January 4, 2007.

g. Stock option plans:

1. Options to employees and others (except consultants)

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

1) 1991 Employee Option Plan - 2,115,600 shares reserved for issuance, of which 53,592 were available for future grants to employees as of December 31, 2003.

2) 1993 Employee Option Plan - as amended, 6,200,000 shares reserved for issuance, of which no shares were available for future grants to employees as of December 31, 2003.

3) 1998 Employee Option Plan - as amended, 4,750,000 shares reserved for issuance, of which no shares were available for future grants to employees and consultants as of December 31, 2003.

4) 1995 Non-Employee Director Plan - 1,000,000 shares reserved for issuance, of which 600,000 were available for future grants to directors as of December 31, 2003.

b. Under these plans, options generally expire no later than 10 years from the date of grant. Each option can be exercised to purchase one share, conferring the same rights as the other common

Edgar Filing: AROTECH CORP - Form 10-K/A

shares. Options that are cancelled or forfeited before expiration become available for future grants. The options generally vest over a three-year period (33.3% per annum).

c. A summary of the status of the Company's plans and other share options (except for options granted to consultants) granted as of December 31, 2003, 2002 and 2001, and changes during the years ended on those dates, is presented below:

F - 35

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

	2003		2002		2001	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		\$		\$		
Options outstanding at beginning of year	5,260,366	\$2.26	4,240,228	\$2.74	2,624,225	\$3.14
Changes during year:						
Granted (1) (2)	5,264,260	\$0.71	1,634,567	\$0.87	2,172,314	\$1.29
Exercised (3)	689,640	\$0.64	(191,542)	\$1.29	(159,965)	\$1.29
Forfeited or cancelled	(816,675)	\$3.51	(422,887)	\$1.92	(396,346)	\$4.14
Options outstanding at end of year	9,018,311	\$1.37	5,260,366	\$2.26	4,240,228	\$2.74
Options exercisable at end of year	5,826,539	\$1.70	4,675,443	\$2.26	2,643,987	\$2.74

(1) Includes 2,035,000, 481,435 and 1,189,749 options granted to related parties in 2003, 2002 and 2001, respectively.

(2) The Company recorded deferred stock compensation for options issued with an exercise price below the fair value of the common stock in the amount of \$4,750, \$0 and \$18,000 as of December 31, 2003, 2002 and 2001, respectively. Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options to employees and directors in 2003, 2002 and 2001, was \$8,286, \$6,000 and \$17,240, respectively.

(3) In June 2002 and December 2001, the employees exercised 100,000 and 33,314, respectively, options for which the exercise price was not paid at the exercise date. The Company recorded the owed amount of \$73,000 and

Edgar Filing: AROTECH CORP - Form 10-K/A

\$43,308, respectively, as "Note receivable from shareholders" in the statement of shareholders' equity. In accordance with EITF 95-16, since the original option grant did not permit the exercise of the options through loans, and due to the Company's history of granting non-recourse loans, this postponement in payments of the exercise price resulted in a variable plan accounting. However, the Company did not record any compensation due to the decrease in the market value of the Company's shares during 2001 and 2002. During the year 2002 the notes in the amount of \$43,308 were entirely repaid and note at the amount of \$36,500 was forgiven and appropriate compensation was recorded. During the year 2003, the company recorded compensation in amount of \$38,500 due to increase in the market value of the company's shares.

d. The options outstanding as of December 31, 2003 have been separated into ranges of exercise price, as follows:

Range of exercise prices	Total options outstanding			Exercisable options outstanding		
	Amount outstanding at December 31, 2003	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2003	Weighted average exercise price	
\$		Years	\$		\$	
0.01-2.00	7,773,767	7.48	0.90	4,584,740	0.98	
2.01-4.00	314,544	3.56	3.07	314,544	3.07	
4.01-6.00	885,000	6.28	4.60	882,255	4.60	
6.01-8.00	35,000	2.05	7.73	35,000	7.73	
8.01	10,000	3.75	9.06	10,000	9.06	
	9,018,311	7.20	1.37	5,826,539	1.70	
	=====	=====	=====	=====	=====	

F - 36

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

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

Equals market price			Exceeds market price			Less than market	
Year ended December 31,			Year ended December 31,			Year ended Decemb	
2003	2002	2001	2003	2002	2001	2003	2002
-----	-----	-----	-----	-----	-----	-----	-----

Edgar Filing: AROTECH CORP - Form 10-K/A

Weighted average exercise prices	\$0.950	\$1.265	\$1.579	\$ --	\$ --	\$1.466	\$ --	\$0.755
Weighted average fair value on grant date	\$0.730	\$0.560	\$0.500	\$ --	\$ --	\$0.560	\$ --	\$0.250

2. Options issued to consultants:

a. The Company's outstanding options to consultants as of December 31, 2003, are as follows:

	2003		2002		2001
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount
		\$		\$	
Options outstanding at beginning of year	245,786	\$ 5.55	245,786	\$ 5.55	175,786
Changes during year:					
Granted (1)	83,115	\$ 0.99	--	--	130,000
Exercised	(15,000)	\$ 0.49	--	--	(60,000)
Repriced (2):					
Old exercise price	--	--	--	--	(56,821)
New exercise price	--	--	--	--	56,821
Options outstanding at end of year	313,901	\$ 4.59	245,786	\$ 5.55	245,786
Options exercisable at end of year	193,901	\$ 3.46	125,786	\$ 6.42	125,786

(1) 120,000 options out of 130,000 options granted in 2001 to the Company's selling and marketing consultants are subject to the achievement of the targets specified in the agreements with these consultants. The measurement date for these options has not yet occurred, as these targets have not been met, in accordance with EITF 96-18. When the targets is achieved the Company will record appropriate compensation upon the fair value at the same date at which the targets is achieved

(2) During the year 2001 the Company repriced 56,821 options to its service providers. The fair value of repriced warrants was calculated as a difference measured between (1) the fair value of the modified warrants determined in accordance with the provisions of SFAS 123, and (2) the value of the old warrant immediately before its terms were modified, determined based on the shorter of (a) its remaining expected life or (b) the expected life of the modified option. As a result of the repricing, the Company has recorded an additional compensation at the amount of \$21,704, and included this amount in marketing expenses.

Edgar Filing: AROTECH CORP - Form 10-K/A

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

	2003 ----	2002 ----	2001 ----
Dividend yield	0%	--	0%
Expected volatility	78%	--	82%
Risk-free interest	2.3%	--	3.5-4.5%
Contractual life of up to	10 years	--	10 years

F - 37

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

c. In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling \$29,759, \$0 and \$139,291 for the years ended December 31, 2003, 2002 and 2001, respectively, and included these amounts in marketing and general and administrative expenses.

3. Dividends:

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

4. Treasury Stock:

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

h. Issuances in connection with acquisitions:

In September 2003, the Company acquired an additional 12% interest in MDT Armor Corporation and an additional 24.5% interest in MDT Protective Industries Ltd. in exchange for the issuance to AGA Means of Protection and Commerce Ltd. of 126,000 shares of its common stock.

F - 38

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- INCOME TAXES

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

As of December 31, 2003, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$17.0 million, which are available

Edgar Filing: AROTECH CORP - Form 10-K/A

to offset future taxable income, if any, expiring in 2010 through 2022. Utilization of U.S net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

b. Israeli subsidiary (EFL):

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

A small part of EFL's manufacturing facility has been granted "Approved Enterprise" status under the Investments Law, and is entitled to investment grants from the State of Israel of 38% on property and equipment located in Jerusalem, and 10% on property and equipment located in its plant in Beit Shemesh, and to reduced tax rates on income arising from the "Approved Enterprise," as detailed below.

The approved investment program is in the amount of approximately \$500,000. EFL effectively operated the program during 1993, and is entitled to the tax benefits available under the Investments Law. EFL is entitled to additional tax benefits as a "foreign investment company," as defined by the Investments Law.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the Company they would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative system of benefits, currently between 25% for an "Approved Enterprise." As of December 31, 2003, the accumulated deficit of the Company does not include tax-exempt profits earned by the Company's "Approved Enterprise."

The entitlement to the above benefits is conditional upon the Company's fulfilling the conditions stipulated by the Investments Law, regulations published thereunder and the instruments of approval for the specific investments in "approved enterprises." In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2003, according to the Company's management, the Company has fulfilled all conditions.

The main tax benefits available to EFL are:

a) Reduced tax rates:

During the period of benefits (seven to ten years), commencing in the first year in which EFL earns taxable income from the "Approved Enterprise," a reduced corporate tax rate of between 10% and 25% (depending on the percentage of foreign ownership, based on present ownership percentages of 15%) will apply, instead of the regular tax rates.

F - 39

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- INCOME TAXES (Cont.)

Edgar Filing: AROTECH CORP - Form 10-K/A

The period of tax benefits, detailed above, is subject to limits of 12 years from the commencement of production, or 14 years from the approval date, whichever is earlier. Hence, the first program will expire in the year 2004. The benefits have not yet been utilized since the Company has no taxable income, since its incorporation.

b) Accelerated depreciation:

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

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 36%.

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

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

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

EFL is an "industrial company," as defined by this law and, as such, is entitled to certain tax benefits, mainly accelerated depreciation, as prescribed by regulations published under the inflationary adjustments law, the right to claim public issuance expenses and amortization of know-how, patents and certain other intangible property rights as deductions for tax purposes.

4. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 36%.

5. Tax loss carryforwards:

As of December 31, 2003, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$84.0 million, which are available, indefinitely, to offset future taxable income.

F - 40

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- INCOME TAXES (Cont.)

c. Deferred income taxes:

Edgar Filing: AROTECH CORP - Form 10-K/A

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

	December 31,	
	2003	2002
Operating loss carryforward	\$ 33,958,434	\$ 29,257,118
Reserve and allowance	843,453	303,204
Net deferred tax asset before valuation allowance	34,801,887	29,560,322
Valuation allowance	(34,801,887)	(29,560,322)
	\$ --	\$ --

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2003 was \$5,241,565.

d. Loss from continuing operations before taxes on income and minority interest in loss (earnings) of a subsidiary:

	Year ended December 31		
	2003	2002	2001
Domestic	\$ (7,411,121)	\$ (5,250,633)	\$ (5,828,828)
Foreign	(1,697,617)	(13,254,195)	(11,457,960)
	\$ (9,108,738)	\$ (18,504,358)	\$ (17,286,788)

* Restated (see Note 1.b.).

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- INCOME TAXES (Cont.)

e. Taxes on income were comprised of the following:

Edgar Filing: AROTECH CORP - Form 10-K/A

	Year ended December 31		
	2003	2002	2001
Current taxes	\$ 44,102	\$ --	\$ --
Taxes in respect of prior years	352,091	--	--
	<u>\$396,193</u>	<u>\$ --</u>	<u>\$ --</u>
Domestic	\$ 33,020	\$ --	\$ --
Foreign	363,173	--	--
	<u>\$396,193</u>	<u>\$ --</u>	<u>\$ --</u>

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

	Year ended December 31,		
	2003	2002	2001
Loss from continuing operations before taxes, as reported in the consolidated statements of income	\$ (9,108,738)	\$ (4,582,792)	\$ (4,025,789)
Statutory tax rate	35%	35%	35%
Theoretical tax income on the above amount at the U.S. statutory tax rate	\$ (3,188,058)	\$ (1,603,977)	\$ (1,409,026)
Deferred taxes on losses for which valuation allowance was not provided	1,178,215	1,603,977	1,409,026
Non-deductible expenses	2,020,290	--	--
State taxes	33,020	--	--
Other	635	--	--
Taxes in respect of prior years due to change in estimates	352,091	--	--
Actual tax expense	<u>\$ 396,193</u>	<u>\$ --</u>	<u>\$ --</u>

 * Restated (see Note 1.b.).

Edgar Filing: AROTECH CORP - Form 10-K/A

NOTE 13:- SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expenses), net:

	Year ended December 31,		
	2003	2002	2001
Financial expenses:			
Interest, bank charges and fees	\$ (355,111)	\$ (89,271)	\$ (49,246)
Amortization of compensation related to beneficial convertible feature of convertible debenture and warrants issued to the holders of convertible debenture	(3,928,237)	--	--
Foreign currency translation differences	115,538	15,202	(16,003)
	(4,167,810)	(74,069)	(65,249)
Financial income:			
Interest	129,101	174,520	327,830
Total	\$ (4,038,709)	\$ 100,451	\$ 262,581

* Restated (see Note 1.b.).

NOTE 14:- RELATED PARTY DISCLOSURES

	Year ended December 31,		
	2003	2002	2001
Transactions:			
Reimbursement of general and administrative expenses	--	\$ 36,000	\$ 23,850
Financial income (expenses), net from notes receivable and loan holders	--	\$ (7,309)	\$ (36,940)

NOTE 15:- SEGMENT INFORMATION

a. General:

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

The Company previously managed its business in three reportable segments

Edgar Filing: AROTECH CORP - Form 10-K/A

organized on the basis of differences in its related products and services. With the discontinuance of Consumer Batteries segment (see Note 1.e-Discontinued Operation) and acquiring two subsidiaries (see Notes 1.b.and c.), two reportable segments remain: Electric Fuel Batteries, and Defense and Security Products. As a result the Company reclassified information previously reported in order to comply with new segment reporting.

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

F - 43

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 15:- SEGMENT INFORMATION (Cont.)

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

	Batteries	Defense and Security Products	All Other
	-----	-----	-----
2003*			
Revenues from outside customers	\$ 5,868,899	\$ 11,457,742	\$ --
Depreciation expense and amortization	(527,775)	(927,665)	(139,629)
Direct expenses (1)	(5,945,948)	(10,892,933)	(4,200,772)
	-----	-----	-----
Segment gross loss	(604,824)	(362,856)	(4,340,401)
	=====	=====	=====
Financial income (in deduction of minority rights)	--	--	--
Net loss from continuing operation			
Segment assets (2)	2,128,062	1,628,562	450,864
	=====	=====	=====
Expenditures for segment assets	247,989	208,497	124,463
	=====	=====	=====
2002			
Revenues from outside customers	\$ 1,682,296	\$ 4,724,443	\$ --
Depreciation expense and amortization	(252,514)	(676,753)	(194,014)
Direct expenses (1)	(3,062,548)	(4,353,770)	(2,905,743)
	-----	-----	-----
Segment gross loss	\$ (1,632,766)	\$ (306,080)	\$ (3,099,757)
	=====	=====	=====
Financial income			

Edgar Filing: AROTECH CORP - Form 10-K/A

Net loss from continuing operation

Segment assets (2)	\$ 2,007,291	\$ 1,683,825	\$ 575,612
Expenditures for segment assets	\$ 246,664	\$ 58,954	\$ 70,486

2001

Revenues from outside customers	\$ 2,093,632	\$ --	\$ --
Depreciation expense	(304,438)	--	(225,577)
Direct expenses (1)	(2,295,501)	--	(3,556,486)
Segment gross loss	\$ (506,307)	\$ --	\$ (3,782,063)

Financial income net

Net loss from continuing operations

Segment assets (2)	\$ 2,044,257	\$ 1,175,521	\$ 702,915
Expenditures for segment assets	\$ 229,099	\$ 229,099	\$ 323,985

* Restated (see Note 1.b.).

(1) Including sales and marketing, general and administrative expenses.

(2) Including property and equipment and inventory.

F - 44

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 15:- SEGMENT INFORMATION (Cont.)

c. Summary information about geographic areas:

The following presents total revenues according to end customers location for the years ended December 31, 2003, 2002 and 2001, and long-lived assets as of December 31, 2003, 2002 and 2001:

	2003		2002		2001
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues
			U.S. dollars		
U.S.A.	\$10,099,652	\$ 6,778,050	\$ 2,787,250	\$ 6,710,367	\$ 1,057,939
Germany	2,836,725	-	38,160	-	526,766

Edgar Filing: AROTECH CORP - Form 10-K/A

England	29,095	-	47,696	-	36,648
Thailand	95,434	-	291,200	-	-
Israel	3,576,139	2,954,441	2,799,365	3,367,320	13,773
Other	689,596	-	443,068	-	458,506
	-----	-----	-----	-----	-----
	\$17,326,641	\$ 9,732,491	\$ 6,406,739	\$ 10,077,687	\$ 2,093,632
	=====	=====	=====	=====	=====

d. Revenues from major customers:

	Year ended December 31,		
	2003	2002 %	2001
	-----	-----	-----
Electric Fuel Batteries:			
Customer A	--	--	22%
Customer B	2%	7%	20%
Customer C	1%	2%	13%
Customer D	27%	8%	12%
Defense and Security Products:			
Customer A	17%	43%	--
Customer B	16%	--	--

e. Revenues from major products:

	Year ended December 31,		
	2003	2002	2001
	-----	-----	-----
EV	\$ 408,161	\$ 460,562	\$ 894,045
WAB	703,084	647,896	951,598
Military batteries	4,757,116	573,839	247,989
Car armoring	3,435,715	2,744,382	-
Interactive use-of-force training	7,961,302	1,980,060	-
Other	61,263	-	-
	-----	-----	-----
Total	\$17,326,641	\$6,406,749	\$2,093,632
	=====	=====	=====

F - 45

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:- CONVERTIBLE DEBENTURES

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

Edgar Filing: AROTECH CORP - Form 10-K/A

Pursuant to the terms of a Securities Purchase Agreement dated December 31, 2002, the Company issued and sold to a group of institutional investors an aggregate principal amount of 9% secured convertible debentures in the amount of \$3.5 million due June 30, 2005. These debentures are convertible at any time prior to June 30, 2005 at a conversion price of \$0.75 per share, or a maximum aggregate of 4,666,667 shares of common stock. The conversion price of these debentures was adjusted to \$0.64 per share in April 2003. In accordance with EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," the terms of convertible debentures are not treated as changed or modified when the cash flow effect on a present value basis is less than 10%, and therefore the Company did not record any compensation related to the change in the conversion price of the convertible debentures.

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

This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" ("APB No. 14") and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 64%, dividend yields of 0% and a contractual life of five years.

During 2003, an aggregate of \$2,350,000 in 9% secured convertible debentures was converted into an aggregate of 3,671,875 shares of common stock and an aggregate of 1,500,042 shares were issued pursuant to exercises of the warrants.

In connection with these convertible debentures, the Company recorded a deferred debt discount of \$1,890,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - June 30, 2005 - or to the actual conversion date, as earlier, as financial expenses.

During 2003 the Company recorded an expense of \$1,517,400, of which \$548,100 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$969,300 was attributable to amortization due to conversion of the convertible debenture into shares.

F - 46

AROTECH CORPORATION AND ITS SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:- CONVERTIBLE DEBENTURES (Cont.)

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

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

Edgar Filing: AROTECH CORP - Form 10-K/A

2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$5.0 million due September 30, 2006. These debentures are convertible at any time prior to September 30, 2006 at a conversion price of \$1.15 per share, or a maximum aggregate of 4,347,826 shares of common stock.

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

This transaction was accounted according to APB No. 14 "Accounting for Convertible debt and Debt Issued with Stock Purchase Warrants" ("APB No. 14") 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 recorded a deferred debt discount of \$2,963,043 with respect to the beneficial conversion feature and the discount arising from fair value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - or to the actual conversion date, as earlier, as financial expenses.

During 2003, an aggregate of \$3,775,000 in 8% secured convertible debentures was converted into an aggregate of 3,282,608 shares of common stock and an aggregate of 437,500 shares were issued pursuant to exercises of the warrants.

During 2003 the Company recorded an expense of \$2,298,034, of which \$205,858 was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$2,092,176 was attributable to amortization due to conversion of the convertible debenture into shares.

c. 8% Secured Convertible Debentures due December 31, 2006

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$6.0 million due December 31, 2006. These debentures are convertible at any time prior to December 31, 2006 at a conversion price of \$1.45 per share, or a maximum aggregate of 4,137,931 shares of common stock.

As a further part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due 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 December 31, 2006 at a price of \$2.20 per share.

F - 47

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 16:- CONVERTIBLE DEBENTURES (Cont.)

Edgar Filing: AROTECH CORP - Form 10-K/A

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

In connection with these convertible debentures, the Company recorded a deferred debt discount of \$6,000,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - December 31, 2006 - or to the actual conversion date, as earlier, as financial expenses.

During 2003 the Company recorded an expense of \$112,803, which represents the amortization of the beneficial conversion feature of the convertible debenture over its term.

During the nine months ended September 30, 2004 an aggregate of 1,500,000 shares were issued pursuant to exercise of these warrants. Out of these warrants, the holders of 1,125,000 warrants exercised their warrants on July 14, 2004 were granted an additional warrants to purchase 1,125,000 shares of common stock of the Company at an exercise price per share of \$1.38. See also Note 17.c.

NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED)

a. Debenture conversion:

In January 2004, a total of \$1,150,000 principal amount of 9% debentures was converted into an aggregate of 1,796,875 shares of common stock at a conversion price of \$0.64 per share. Additionally, through November 2004 a total of \$1,075,000 principal amount of 8% debentures was converted into an aggregate of 934,783 shares of common stock at a conversion price of \$1.15 per share, and a total of \$1,612,500 principal amount of 8% debentures was converted into an aggregate of 1,112,069 shares of common stock at a conversion price of \$1.45 per share.

b. Issuance of common stock to investors:

In January 2004, the Company issued to a group of investors an aggregate of 9,840,426 shares of common stock at a price of \$1.88 per share, or a total purchase price of \$18,500,000. (See also Note 17.c.)

c. Issuance of warrants to investors:

As part of the investment agreement in January 2004 (see Note 17.b.), the Company issued to a group of investors warrants to purchase an aggregate of 9,840,426 shares of common stock at a price of \$1.88 per share. These warrants are exercisable by the holder at any time after August 12, 2004 and will expire on January 12, 2007. On July 14, 2004 an aggregate of 7,446,811 shares were issued pursuant to exercise of these warrants. In connection with the exercise of the warrants, the Company granted to the same investors five-year warrants to purchase up to an aggregate of 7,446,811 shares of the Company's common stock at an exercise price per share of \$1.38. See Note 17.e.

Edgar Filing: AROTECH CORP - Form 10-K/A

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED) (Cont.)

d. Warrants issued in May 2001:

On July 14, 2004, the Company repriced the exercise price of warrants granted previously in May 2001 (see also Note 11.f.2.) to \$1.88 in order to induce their holders to exercise them immediately. In connection with the exercise of the warrants, the Company additionally granted five-year warrants to purchase up to an aggregate of 145,454 shares of the Company's common stock at an exercise price per share of \$1.38 (See Note 17.e.).

e. Issuance of shares and warrants in July 2004:

In July 2004, pursuant to a Securities Purchase Agreement dated July 15, 2004, the Company issued to a group of investors an aggregate of 4,258,065 shares of common stock at a price of \$1.55 per share, or a total purchase price of \$6,600,000.

On July 14, 2004, warrants to purchase 8,814,235 shares of common stock, having an aggregate exercise price of \$16,494,194, net of issuance expenses, were exercised (see Notes 17.c. and 17.d.). In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 8,717,265 new five-year warrants to purchase shares of common stock at an exercise price of \$1.38 per share.

As a result of the aforesaid transactions, including the repricing of the warrants to the investors and the issuance of additional warrants to the investors, the Company recorded a deemed dividend in the amount of \$2,165,952, to reflect the additional benefit created for these investors.

f. Acquisition of FAAC Incorporated:

In January 2004, the Company purchased all of the outstanding stock of FAAC Incorporated, a Michigan corporation ("FAAC"), from FAAC's existing shareholders. The assets acquired through the purchase of all of FAAC's outstanding stock consisted of all of FAAC's assets, including FAAC's current assets, property and equipment, and other assets (including intangible assets such as goodwill, intellectual property and contractual rights). The consideration for the assets purchased consisted of (i) cash in the amount of \$12,000,000, and (ii) the issuance of \$2,000,000 in Arotech stock, plus an earn-out based on 2004 net pretax profit, with an additional earn-out on the 2005 net profit from certain specific and limited programs. The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities were recorded at their estimated market values as of the date acquired, and results of FAAC's operations have been included in the consolidated financial statements commencing the date of acquisition.

Edgar Filing: AROTECH CORP - Form 10-K/A

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED) (Cont.)

g. Acquisition of Epsilor Electronic Industries, Ltd.:

In January 2004, the Company purchased all of the outstanding stock of Epsilor Electronic Industries, Ltd., an Israeli corporation ("Epsilor"), from Epsilor's existing shareholders. The assets acquired through the purchase of all of Epsilor's outstanding stock consisted of all of Epsilor's assets, including Epsilor's current assets, property and equipment, and other assets (including intangible assets such as goodwill, intellectual property and contractual rights). The consideration for the assets purchased consisted of (i) cash in the amount of \$7,000,000, and (ii) a series of three \$1,000,000 promissory notes, due on the first, second and third anniversaries of the Agreement under the circumstances set forth in the acquisition agreement. The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities acquired were recorded at their estimated market values as of the date of acquisition, and results of Epsilor's operations have been included in the consolidated financial statements commencing the date of acquisition.

h. Settlement of litigation:

On February 4, 2004, the Company entered into an agreement settling the litigation brought against it in the Tel-Aviv, Israel district court by I.E.S. Electronics Industries, Ltd. ("IES Electronics") and certain of its affiliates in connection with the Company's purchase of the assets of its IES Interactive Training, Inc. subsidiary from IES Electronics in August 2002. The litigation had sought monetary damages in the amount of approximately \$3 million. Pursuant to the terms of the settlement agreement, in addition to agreeing to dismiss their lawsuit with prejudice, IES Electronics agreed (i) to cancel the Company's \$450,000 debt to them that had been due on December 31, 2003, and (ii) to transfer to the Company title to certain certificates of deposit in the approximate principal amount of \$112,000. The parties also agreed to exchange mutual releases. In consideration of the foregoing, the Company issued to IES Electronics (i) 450,000 shares of common stock, and (ii) five-year warrants to purchase up to an additional 450,000 shares of common stock at a purchase price of \$1.91 per share. The fair value of the warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of five years.

In respect of the above settlement, the Company recorded in 2003 an expense of \$689,714, representing the fair value of the warrants and shares over the remaining balance of the Company's debt to IES Electronics as carried in the Company books at December 31, 2003, less the \$112,000 certificate of deposit that was transferred to the Company's name as noted above.

i. Acquisition of Armour of America, Incorporated

In August 2004, the Company purchased all of the outstanding stock of Armour of America, Incorporated, a California corporation ("AoA"), from AoA's existing shareholder. The assets acquired through the purchase of all of AoA's outstanding stock consisted of all of AoA's assets, including AoA's current assets, property and equipment, and other assets (including intangible assets such as intellectual property and contractual rights).

Edgar Filing: AROTECH CORP - Form 10-K/A

AROTECH CORPORATION AND ITS SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED) (Cont.)

The total purchase price consisted of \$19,000,000 in cash, with additional possible earn-outs if AoA is awarded certain material contracts. An additional \$3,000,000 was paid into an escrow account pursuant to the terms of an escrow agreement, to secure a portion of the Earnout Consideration. Pursuant to the purchase agreement, the total consideration, sale price plus Earnout Consideration, will not be in excess of \$40,000,000. When the contingency on the earn-out provision is resolved, the additional consideration will be recorded as additional purchase price. The purchase price also included \$83,837 of transaction costs. The transaction has been accounted for using the purchase method of accounting, and accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based upon their fair values at the date the acquisition was completed.

j. Adjustment of warrants issued in 2000 and 2001

In November 2000 and May 2001, the Company issued a total of 916,667 warrants to an investor, which warrants contained certain antidilution provisions: a Series A warrant to purchase 666,667 shares of the Company's common stock at a price of \$3.50 per share, and a Series C warrant to purchase 250,000 shares at a price of \$3.08 per share. Operation of the antidilution provisions provided that the Series A warrant should be adjusted to be a warrant to purchase 888,764 shares at a price of \$2.67 per share, and the Series C warrant should be adjusted to be a warrant to purchase 333,286 shares at a price of \$2.35 per shares. After negotiations, the investor agreed in March 2004 to exercise its warrants immediately, in exchange for an exercise price reduction to \$1.45 per share, and the issuance of a new six-month Series D warrant to purchase 1,222,050 shares at an exercise price of \$2.10 per share. The new Series D warrant does not have similar antidilution provisions. As a result of this repricing and the and the issuance of new warrants, the Company recorded a deemed dividend in the amount of approximately \$1,163,000 in the nine months ended September 30 2004.

F - 51

SUPPLEMENTARY FINANCIAL DATA

Quarterly Financial Data (unaudited) for the two years ended December 31, 2003

	2003	Quarter Ended*			
		March 31	June 30	September 30	
Net revenue.....	\$	4,033,453	\$ 3,493,135	\$ 5,705,898	\$
Gross profit.....	\$	1,399,734	\$ 1,013,965	\$ 2,453,575	\$
Net profit (loss) from continuing operations	\$	(1,291,122)	\$ (2,788,348)	\$ 218,606	\$

Edgar Filing: AROTECH CORP - Form 10-K/A

Net loss from discontinued operations.....	\$	(95,961)	\$	179,127	\$	(2,285)	\$
Net profit (loss) for the period.....	\$	(1,387,083)	\$	(2,609,221)	\$	216,321	\$
Net profit (loss) per share - basic and diluted.....	\$	(0.04)	\$	(0.08)	\$	0.00	\$
Shares used in per share calculation.....		34,758,960		36,209,872		40,371,940	

	2002	Quarter Ended					
		March 31	June 30	September 30			
Net revenue.....	\$	570,545	\$	425,053	\$	3,262,711	\$
Gross profit.....	\$	186,917	\$	48,807	\$	1,593,770	\$
Net loss from continuing operations.....	\$	(990,097)	\$	(1,005,877)	\$	(923,122)	\$
Net loss from discontinued operations.....	\$	(2,324,109)	\$	(1,654,108)	\$	(8,716,422)	\$
Net loss for the period.....	\$	(3,314,208)	\$	(2,659,985)	\$	(9,369,544)	\$
Net loss per share - basic and diluted.....	\$	(0.11)	\$	(0.09)	\$	(0.29)	\$
Shares used in per share calculation.....		30,149,210		30,963,919		33,441,137	

* Restated (see Note 1.b. of Notes to Consolidated Financial Statements).

F - 52

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II - Valuation and Qualifying Accounts

For the Years Ended December 31, 2003, 2002 and 2001

Description	Balance at beginning of period	Additions charged to costs and expenses	Balance at end of period
Year ended December 31, 2003			
Allowance for doubtful accounts.....	\$ 40,636	\$ 20,646	\$ 61,282
Valuation allowance for deferred taxes....	29,560,322	5,241,565	34,801,887
Totals.....	\$ 29,600,958	\$ 5,262,211	\$ 34,863,169
Year ended December 31, 2002			
Allowance for doubtful accounts.....	\$ 39,153	\$ 1,483	\$ 40,636
Valuation allowance for deferred taxes....	12,640,103	16,920,219	29,560,322
Totals.....	\$ 12,679,256	\$ 16,921,702	\$ 29,600,958
Year ended December 31, 2001			
Allowance for doubtful accounts.....	\$ 13,600	\$ 25,553	\$ 39,153
Valuation allowance for deferred taxes....	8,987,750	3,652,353	12,640,103
Totals.....	\$ 9,001,350	\$ 3,677,906	\$ 12,679,256

EXHIBIT INDEX

Exhibit Number -----	Description -----
23	Consent of Kost, Forer, Gabbay & Kassierer, a member of Ernst & Young Global
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	Written Statement of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Written Statement of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002