AROTECH

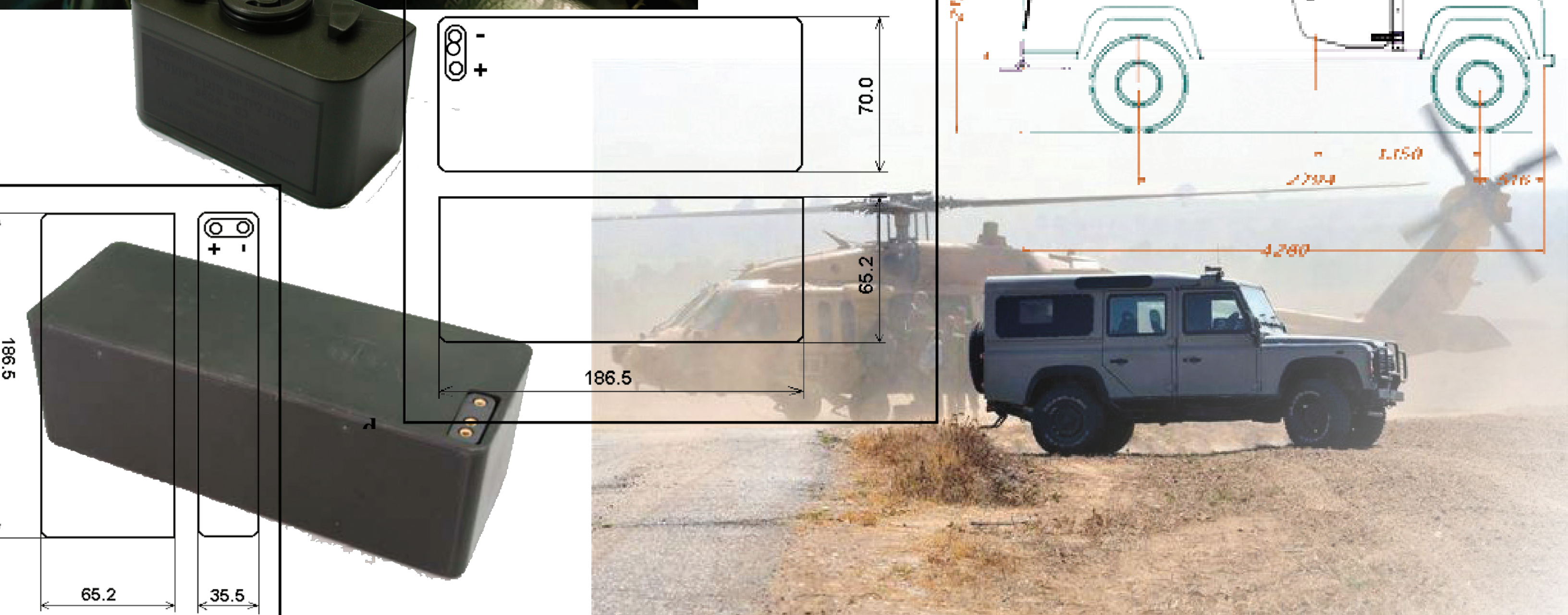
Arotech Corporation Annual Report 2009

Nasdaq: ARTX

LEADING PRODUCTS
FOR MILITARY,
HOMELAND SECURITY,
LAW ENFORCEMENT
AND PUBLIC SAFETY
REQUIREMENTS

We Train
We Protect
We Supply

Training & Simulation
Armor
Battery & Power Systems
Divisions



Arotech Corporation

Annual Report 2009

Nasdaq: ARTX

June 2010

Dear Fellow Shareholder,

As we close out another year for Arotech, I would like to begin with the progress the Company made last year and some comments on how we have re-established ourselves from pure play battery developer in the 1990's to a leading provider of products that train, protect and supply militaries around the world.

In what is still considered a challenging environment, our Company-wide revenues for 2009 reached the highest level ever, with sales approaching $75 million for the year.

Each of our businesses met or exceeded internal growth targets. Our simulation division had another exceptional year, with revenues reaching nearly $40 million during 2009 and an EBITDA of almost $6.5 million. The battery division had its best year ever as well, with revenues of nearly $18 million and an EBITDA of $1 million, while our armor division experienced a relatively flat year, with sales of approximately $17.5, although they were still able to achieve a quarter million in EBITDA. While we continue to grow and increase sales and reduce operating and overhead expenses, we are still affected by various non cash charges related to previous acquisitions, but we were profitable on a non-GAAP basis.

As most of you are aware, Arotech's roots were in the development of battery technologies that are used in a variety of military and consumer applications. From our humble beginnings in 1990, we have developed the Electric Fuel division into a leading supplier of lithium-ion and zinc-air technologies that has achieved consistent positive EBITDA for the last several years and is now consistently profitable.

We added the initial simulation business, FAAC, in 2004 and have grown that division from $21 million in 2006 to nearly $40 million in 2009, for a compounded growth rate of more than 30% annually. During the same period our EBITDA grew from $3.5 million to nearly $6.5 million. Our armor division began with the purchase of MDT in 2002. From that time, the division has grown from a $4 million revenue base into a leading supplier of armor products and armored vehicles to US, Israeli and other customers around the globe. We have shipped close to 1,000 vehicles, and are now developing a family of mine protected vehicles

In our battery division, revenue has grown from $8.6 to $17.9 million, or roughly 100% since 2006, while we have achieved positive, and increasing, EBITDA in each of the last four years. During this time, we have grown from a small division providing portable batteries and rechargeables into a preferred vendor of choice for many of the world's most respected militaries. Our product offerings now include applications in communications equipment, thermal imaging devices, small UAV craft and huge submersibles.

Moreover, our company-wide client list has grown considerably and has included NAVAIR, The US Army, Air Force and Navy, The FBI, The NYPD, NYC MTA, The Israel Defense Force, Police and Government agencies the Iraqi Police and the Canadian, European and Australian Air Forces.

On a consolidated revenue basis, since 2006 we have grown sales from $43 million to $75 million, while increasing EBITDA from a negative $2 million to more than $3 million in 2009. Further, backlog in the last two years has grown nearly 50% to more than $55 million at year end 2009. Long term, the reality is that hostile activity will be around for quite some time and militaries, municipalities and others will need technology and resources that Arotech's divisions provide.

2010 and 2011 have the potential to be years of continuing growth, but they will be highly competitive. Funding for militaries in the U.S., Europe and Asia are all under pressure from legislatures, resulting from the 2008-09 financial crisis. We continue to be optimistic, but recognize that achieving growth will be extremely hard work.

As we reflect on the outlook for 2010, it is evident that we've all been through a lot as a result of the great recession and the global credit crisis. I have to extend my sincere thanks and appreciation to the employees of Arotech and our supply chain partners for going the extra mile during these difficult times and working extremely hard to ensure that Arotech enters fiscal 2010 with a strong foundation and solid outlook. I'm proud that we moved decisively to shed costs and repay debt while still maintaining a sharp focus on our customers and capturing new businesses that we believe will lead us in to the eventual economic recovery.

Sincerely,

Robert S. Ehrlich
Chairman and Chief Executive Officer

The text for this annual report was taken principally from our Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2010.

Safe Harbor Statement. *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.*

General

We are a defense and security products and services company, engaged in three business areas: high-level armoring for military and nonmilitary air and ground vehicles; interactive simulation for military, law enforcement and commercial markets; and batteries and charging systems for the military. We operate primarily through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned by us) are as follows:

- We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our ***Training and Simulation Division***:
  - We provide simulators, systems engineering and software products to the United States military, government and private industry through our subsidiary FAAC Incorporated, located in Ann Arbor, Michigan ("FAAC"); and
  - We provide specialized "use of force" training for police, security personnel and the military through our subsidiary IES Interactive Training, located in Ann Arbor, Michigan, which we merged into our FAAC subsidiary in October of 2007 ("IES").
- We utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles and to manufacture personal and aviation armor through our ***Armor Division***:
  - We use state-of-the-art lightweight armoring materials, special ballistic glass and advanced engineering processes to fully armor military vehicles and civilian SUV's, buses and vans, through our subsidiaries MDT Protective Industries, Ltd., located in Lod, Israel ("MDT"), and MDT Armor Corporation, located in Auburn, Alabama ("MDT Armor"); and
  - Through MDT Armor, we provide ballistic armor kits for rotary and fixed wing aircraft under the trade name Armour of America ("AoA").
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications through our ***Battery and Power Systems Division***:
  - We develop and sell rechargeable and primary lithium batteries and smart chargers to the military and to private defense industry in the Middle East, Europe and Asia through our subsidiary Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area) ("Epsilor");
  - We develop, manufacture and market primary Zinc-Air batteries, rechargeable batteries and battery chargers for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama ("EFB"); and
  - We produce water-activated lifejacket lights for commercial aviation and marine applications through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel ("EFL").

Background

We were incorporated in Delaware in 1990 under the name "Electric Fuel Corporation," and we changed our name to "Arotech Corporation" on September 17, 2003. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech's wholly-owned Israeli subsidiaries, EFL, Epsilor and MDT; and Arotech's wholly-owned United States subsidiaries, EFB, FAAC and MDT Armor. Additionally, we operate under the trade names of IES Interactive (IES), Realtime Technologies, Inc, (RTI) and Armour of America (AoA).

For financial information concerning the business segments in which we operate, see Note 16.b. of the Notes to the Consolidated Financial Statements. For financial information about geographic areas in which we engage in business, see Note 16.c. of the Notes to the Consolidated Financial Statements.

Facilities

Our principal executive offices are located at 1229 Oak Valley Drive, Ann Arbor, Michigan

48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our periodic reports, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at http://www.arotech.com/compro/investor.html, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this annual report.

The offices and facilities of three of our principal 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 the members of our senior management work extensively out of EFL's facilities; our financial operations are conducted primarily from our principal executive offices in Ann Arbor. FAAC's home offices and facilities are located in Ann Arbor, Michigan and in Royal Oak, Michigan. The facilities of EFB and MDT Armor are located in Auburn, Alabama.

Training and Simulation Division

We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driver training of military, law enforcement, security and other personnel through our Training and Simulation Division, the largest of our three divisions. During 2009 and 2008, revenues from our Training and Simulation Division were approximately $39.2 million and $36.0 million, respectively.

The Training and Simulation Division concentrates on three different product areas:

- Our *Vehicle Simulation* group provides high fidelity vehicle simulators for use in operator training and is marketed under our FAAC and Realtime Technologies nameplates;
- Our *Military Operations* group provides weapon simulations used to train military pilots in the effective use of air launched weapons and is also marketed under our FAAC nameplate; and
- Our *Use of Force* group provides training products focused on the proper employment of hand carried weapons and is marketed under our IES Interactive Training nameplate.

Vehicle Simulation

We provide simulators, systems engineering and software products focused on training vehicle operators for cars and trucks. We provide these products to the United States military, government, municipalities, and private industry through our FAAC nameplate. Our fully interactive driver-training systems feature state-of-the-art vehicle simulator technology enabling training in situation awareness, risk analysis and decision making, emergency reaction and avoidance procedures, and proper equipment operation techniques. Our simulators have successfully trained hundreds of thousands of drivers.

Our Vehicle Simulation group focuses on the development and delivery of complete driving simulations for a wide range of vehicle types – such as trucks, automobiles, subway trains, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles. In 2009, our Vehicle Simulations group accounted for approximately 71% of our Training and Simulation Division's revenues.

We believe that we have held a dominant market share in U.S. military wheeled vehicle operator driver training simulators since 1999 and that we are currently one of three significant participants in the U.S. municipal wheeled vehicle simulators market.

In January of 2008 we added Realtime Technologies Incorporated to our Vehicle Simulation group. RTI specializes in multi-body vehicle dynamics modeling and graphical simulation solutions. RTI offers simulation software applications, consulting services, and custom software and hardware development services primarily for use by the automobile industry and universities engaged in the study of vehicle performance or operator/vehicle interactions. We merged RTI into FAAC in January 2010.

Military Operations

In the area of Military Operations, we believe we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare systems for all branches of the Department of Defense and its related industrial contractors. Our simulations are found in systems ranging from instrumented air combat and maneuver training ranges (such as Top Gun), full task training devices such as the F-18

Weapon Tactics Trainer, and in the on-board computer of many fighter jet aircraft. We supply on-board software to support weapon launch decisions for the F-15, F-16, F-18, and Joint Strike Fighter (JSF) fighter aircraft. In 2009, our Military Operations group accounted for 16% of our Training and Simulation Division's revenues.

Use-of-Force

We are a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, security, military and similar applications. With a large customer base spread over twenty countries around the world, we are a leader in the supply of simulation training products to law enforcement, governmental, and commercial clients. We conduct our interactive training activities and market our interactive training products, such as the MILO (Multiple Interactive Learning/training Objectives) System, the A2Z Classroom Trainer (a state-of-the-art Computer Based Training (CBT) system that allows students to interact with realistic interactive scenarios projected life-size in the classroom), and the Range FDU (firearm diagnostics unit), using our IES Interactive Training nameplate. In 2009, our Use of Force group accounted for 13% of our Training and Simulation Division's revenues.

Marketing and Customers

We market our Simulation Division products to all branches of the U.S. military, federal and local government, municipal transportation departments, and public safety groups. Municipalities throughout the U.S. are using our vehicle simulators and use-of-force products, and our penetration in Asia, Europe and the Americas continues through the use of commissioned sales agents and regional distributors.

We have long-term relationships, many of over ten years' duration, with the U.S. Air Force, U.S. Navy, U.S. Army, U.S. Marine Corps, Department of Homeland Security, and most major Department of Defense training and simulation prime contractors and related subcontractors. The quality of our customer relationships is illustrated by the multiple program contract awards we have earned from many of our customers.

Competition

Our technical excellence, superior product reliability, and high customer satisfaction have enabled us to develop market leadership and attractive competitive positions in each of our product areas.

Vehicle Simulators

Several potential competitors in this segment are large, diversified defense and aerospace conglomerates who do not focus on our specific niches. As such, we are able to provide service on certain large military contracts through strategic agreements with these organizations or can compete directly with these organizations based on our strength in developing higher quality software solutions. In municipal market applications, we compete against smaller, less sophisticated software companies. Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

Military Operations

Currently no significant competitors participate in the markets we serve around our weapon simulation niche. Our over 30-year history in this space provides a library of resources that would require a competitor to invest heavily in to offer a comparable product. The companies that could logically compete with us if they chose would be the companies that now subcontract this work to us: Boeing, Raytheon and Cubic.

Use of Force

We compete against a number of established companies that provide similar products and services, many of which have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours. There are also companies whose products do not compete directly, but are sometimes closely related. Firearms Training Systems, Inc., Advanced Interactive Systems, Inc., and LaserShot Inc. are our main competitors in this space.

Armor Division

We armor vehicles and manufacture aviation and other armor through our Armor Division. During 2009 and 2008, revenues from our Armor Division were approximately $17.5 million and $17.7 million, respectively.

Introduction

We specialize in armoring vehicles and manufacturing armor kits for aircraft and vessels by using state-of-the-art lightweight ballistic materials, special ballistic glass and advanced engineering processes. We fully armor military vehicles and civilian SUVs, buses and vans. Through MDT Armor, we also provide ballistic armor kits for rotary and fixed wing aircraft under the trade name Armour of America.

We operate through two business units: MDT Protective Industries Ltd., located in Lod, Israel and MDT Armor Corporation, located in Auburn, Alabama.

We are a leading supplier to the Israeli military, Israeli Special Forces and special services. We provide products to the U.S. Army, and to military and defense and paramilitary customers worldwide. We are also actively exploring marketing armor products in India, through Concord Safety Solutions Pvt. Ltd., an Indian company that we own in equal thirds with an Indian vehicle company and an Indian armoring company.

Our products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide. We have acquired many years of battlefield experience in Israel. Our vehicles have provided proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings.

During 2009, we received over $12.0 million in orders from the Israel Defense Forces for the U.S.-built David, a patrol, combat command and reconnaissance armored vehicle that is specifically designed as an urban combat vehicle. We also introduced the Tiger, a new cost-effective, highly-armored light protected all-terrain vehicle.

Our proprietary designs have been developed to meet a wide variety of customer and industry needs.

Sales, Marketing and Customers

Most of our vehicle armoring business has historically come from Israel, although we have armored vehicles under contracts for companies operating in Iraq. Our principal customer at present is the Israeli Ministry of Defense. Other customers include Israeli and American government ministries and agencies, private companies, medical services and private clients. In the United States, we have armored vehicles for U.S. operations in Iraq.

In Israel, we market our vehicle armoring through vehicle importers, both pursuant to marketing agreements and otherwise, and directly to private customers in the public and private sectors. Most sales are through vehicle importers. In the U.S., vehicles are sold to the Army.

Our commercial aircraft customers have included Bell Helicopter, MD Helicopter, Robinson Helicopter, Sikorsky Helicopter, Schweitzer Helicopter, Agusta, and Lockheed-Martin in the United States, as well as Eurocopter (Germany), Alenia Aerospazio (Italy), EADS (Spain), and Bell (Canada).

Our U.S. military aircraft customers have included NAVSEA, NAVAIR, Army, Coast Guard, Marines, State Department, Border Patrol, and various SEAL and Small Boat Units.

Our foreign military customers have included the air forces of New Zealand, Australia, Thailand, Malaysia, Spain, Belgium, Sweden, Norway, Italy, Sri Lanka, Indonesia, Brazil, Argentina, and Turkey; the navies of Singapore, Thailand, Malaysia, Ecuador, Mexico, Colombia, Spain, Australia, and Japan; the armies of Thailand, Malaysia, Sri Lanka, Colombia, Mexico, Ecuador, Venezuela and Peru.

Manufacturing

Our manufacturing facilities are located in Lod, Israel, and in Auburn, Alabama. In Israel we manufacture armored vehicles only, and in the U.S. we manufacture vehicle armoring, and hard and soft armor.

Our facilities have been awarded ISO 9001:2000 quality standards certification.

Competition

The global armored car industry is highly fragmented. Major suppliers include both vehicle manufacturers and aftermarket specialists. As a highly labor-intensive process, vehicle armoring is numerically dominated by relatively small businesses. Industry estimates place the number of companies doing vehicle armoring in the range of around 500 suppliers globally. While certain large companies may armor several hundred cars annually, most of these companies are smaller operations that may armor in the range of five to fifty cars per year.

Among vehicle manufacturers, we believe Mercedes-Benz to have the largest vehicle-armoring market share. Among aftermarket specialists, we believe the largest share of the vehicle-armoring market is held by O'Gara-Hess & Eisenhardt, a subsidiary of Armor Holdings, Inc. Other aftermarket specialists include International Armoring Corp., Lasco, Texas Armoring and Chicago Armor (Moloney). Many of these companies have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

In military and police armored vehicles, our competitors include Plasan Sasa, BAE Systems, Oshkosh, International Navistar, Jankel Armouring Limited, General Dynamics Land Systems, and Lenco Industries Inc.

We believe the key factor in our competing successfully in this field will be our ability to penetrate new military and paramilitary markets outside of Israel, particularly those operating in Iraq and Afghanistan.

Battery and Power Systems Division

We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications through our Battery and Power Systems Division. During 2009 and 2008, revenues from our Battery and Power Systems Division were approximately $17.8 million and $15.2 million, respectively.

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

We sell lithium batteries and charging systems to the military through our subsidiary Epsilor Electronic Industries, Ltd., an Israeli corporation established in 1985.

We specialize in the design and manufacture of primary and rechargeable batteries, related electronic circuits and associated chargers for military applications. We have experience in working with government agencies, the military and large corporations. Our technical team has significant expertise in the fields of electrochemistry, electronics, software and battery design, production, packaging and testing.

We have added lithium-ion battery production capabilities at EFB's facility in Auburn. The goal is to enable U.S.-produced lithium-ion batteries and chargers to be sold using funding from Foreign Military Funding (FMF) program to countries such as Israel and Turkey. These products are marketed and designed by Epsilor and manufactured by EFB.

COMPETITION

The main competitors for our lithium-ion battery products are Bren-tronics Inc. in the United States, which controls much of the U.S. rechargeable market, ABSL Power Solutions Limited (a wholly owned subsidiary of CIP Industries Incorporated LLP) in the United Kingdom, which has the majority of the English military market, and Ultralife Batteries, Inc. in the United States. On the primary end of the market there are a host of players who include the cell manufacturers themselves, including Saft S.A. and Ultralife Batteries, Inc.

It should be noted that a number of OEMs, such as Motorola, have internal engineering groups that can develop competitive products in-house. Additionally, many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

MARKETING

We market to our existing customers through direct sales. To generate new customers and applications, we rely on our working relationship with a selection of OEMs, with the intent of having these OEMs design our products into their equipment, thereby creating a market with a high entry barrier. Another avenue for market entry is via strategic relationships with major cell manufacturers.

MANUFACTURING

Our battery production lines for military batteries and chargers have been ISO-9001 certified since 1994. We believe that Epsilor's 19,000 square foot facility in Dimona, Israel has the necessary capabilities and operations to support our production cycle.

Zinc-Air Batteries and Chargers for the Military

INTRODUCTION

We base our strategy in the field of Zinc-Air military batteries on the development and commercialization of our Zinc-Air battery technology, as applied in the batteries we produce for the U.S. Army's Communications and Electronics Command (CECOM) through our subsidiary EFB. We will continue to seek new applications for our technology in defense projects, wherever synergistic technology and business benefits may exist. We intend to continue to develop our battery products for defense agencies, and plan to sell our products either directly to such agencies or through prime contractors. We will also look to extend our reach to military markets outside the United States.

Our batteries have been used in both Afghanistan (Operation Enduring Freedom) and in Iraq (Operation Iraqi Freedom). In June of 2004, our BA-8180/U Zinc-Air battery was recognized by the U.S Army Research, Development and Engineering Command as one of the top ten inventions of 2003.

Our Zinc-Air batteries, rechargeable batteries and battery chargers for the military are manufactured through EFB. In 2003, EFB's facilities were granted ISO 9001 "Top Quality Standard" certification.

Markets/Applications

As an external alternative to the popular lithium based BA-5590/U, the BA-8180/U can be used in many applications operated by the BA-5590/U. The BA-8180/U can be used for a variety of military applications.

Customers

The principal customers for our Zinc-Air batteries during 2009 were the U.S. Army's Communications-Electronics Command (CECOM) and the Defense Logistics Agency (DLA). In addition, we continue to further penetrate Special Forces and other specific U.S. military units with direct sales.

Competition

The BA-8180/U is the only Zinc-Air battery to hold a US Army battery designation and an NSN. It does, however, compete with other primary (disposable) batteries, and primarily lithium based batteries. In some cases it will also compete with rechargeable batteries.

Zinc-Air batteries are inherently safer than primary lithium battery packs in storage, transportation, use, and disposal, and are more cost-effective. They are lightweight, with up to twice the energy density of primary lithium battery packs. Zinc-Air batteries for the military are also under development by Rayovac Corporation. Rayovac's military Zinc-Air batteries utilize cylindrical cells, rather than the prismatic cells that we developed. While cylindrical cells may provide higher specific power than our prismatic cells, we believe they will generally have lower energy densities and be more difficult to manufacture.

The most popular competing primary battery in use by the US Armed Forces is the BA-5590/U, which uses lithium-sulfur dioxide ($LiSO_2$) cells. The largest suppliers of $LiSO_2$ batteries to the US military are believed to be Saft America Inc. and Eagle Picher Technologies LLC. The battery compartment of most military communications equipment, as well as other military equipment, is designed for the XX90 family of batteries, of which the BA-5590/U battery is the most commonly deployed. Another primary battery in this family is the BA-5390/U, which uses lithium-manganese dioxide ($LiMnO_2$) cells. Suppliers of $LiMnO_2$ batteries include Ultralife Batteries Inc., Saft and Eagle Picher.

Rechargeable batteries in the XX90 family include lithium-ion (BB-2590/U) and nickel-metal hydride (BB-390/U) batteries which may be used in training missions in order to save the higher costs associated with primary batteries. These rechargeable batteries are also become more prevalent in combat use as their energy densities improve, their availability expands and their State-of-Charge Indicator (SOCI) technologies become more reliable.

Our BA-8180/U does not fit inside the XX90 battery compartment of any military equipment, and therefore is connected externally using an interface adapter that we also sell to the Army. Our battery offers greatly extended mission time, along with lower total mission cost, and these significant advantages often greatly outweigh the slight inconvenience of fielding an external battery.

Manufacturing

EFB maintains a battery and electronics development and manufacturing facility in Auburn, Alabama, housed in a 30,000-square-foot light industrial space leased from the city of Auburn. We also have production capabilities for some battery components at EFL's facility in Beit Shemesh, Israel. Both of these facilities have received ISO 9001 "Top Quality Standard" certification.

Lifejacket Lights

Products

We have a product line consisting of seven lifejacket light models, five for use with marine life jackets and two for use with aviation life vests, all of which work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations. We manufacture, assemble and package all our lifejacket lights through EFL in our factory in Beit Shemesh, Israel.

Marketing

We market our marine safety products through our own network of distributors in Europe, the United States, Asia and Oceania.

We market our lights to the commercial aviation industry through an independent company that receives a commission on sales.

COMPETITION

The largest manufacturer of aviation and marine safety products, including TSO and SOLAS-approved lifejacket lights, is ACR Electronics Inc. of Hollywood, Florida. Other significant competitors in the marine market include Daniamant Aps of Denmark and England, and SIC of Italy.

Backlog

We generally sell our products under standard purchase orders. Orders constituting our backlog are subject to changes in delivery schedules and are typically cancelable by our customers until a specified time prior to the scheduled delivery date. Accordingly, our backlog is not necessarily an accurate indication of future sales. As of December 31, 2009 and 2008, our backlog for the following year was approximately $55.5 million and $36.6 million, respectively, divided among our divisions as follows:

Division	2009	2008
Training and Simulation Division	$ 31,245,000	$ 16,503,000
Armor Division	10,468,000	7,874,000
Battery and Power Systems Division	13,802,000	12,226,000
TOTAL:	$ 55,515,000	$ 36,603,000

Major Customers

During 2009 and 2008, including all of our divisions, various branches of the United States military accounted for approximately 50% and 54% of our revenues.

Price Range of Common Stock

Our common stock is traded on the Nasdaq Global Market. Our Nasdaq ticker symbol is "ARTX." The following table sets forth, for the periods indicated, the range of high and low closing sales prices of our common stock on the Nasdaq Global Market System:

Year Ended December 31, 2009	High	Low
Fourth Quarter	$ 2.35	$ 1.30
Third Quarter	$ 2.00	$ 1.25
Second Quarter	$ 2.17	$ 0.67
First Quarter	$ 0.83	$ 0.37

Year Ended December 31, 2008	High	Low
Fourth Quarter	$ 1.13	$ 0.39
Third Quarter	$ 2.07	$ 1.02
Second Quarter	$ 2.70	$ 2.00
First Quarter	$ 2.73	$ 1.66

As of February 28, 2010 we had approximately 234 holders of record of our common stock.

Share Repurchase Program

In February of 2009, we authorized, for a period of one year, the repurchase in the open market or in privately negotiated transactions of up to $1 million of our common stock. Through September 30, 2009, we repurchased 421,306 shares for a total of $511,659. The following table shows information relating to the repurchase of our common stock during the three months ended December 31, 2009; through such date, 447,358 shares had been purchased for a total cost of $563,556:

Period	Total Number of Shares Purchased	Average Price Paid Per Share[1]	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans
October 1, 2009 through October 31, 2009	0	$ –	0	$ 488,341
November 1, 2009 through November 30, 2009	15,000	$ 1.67	15,000	$ 463,262
December 1, 2009 through December 31, 2009	11,052	$ 1.57	11,052	$ 445,901
TOTAL THIS QUARTER	26,052		26,052	

[1] Average price paid per share includes commissions and is rounded to the nearest two decimal places.

The repurchase program is subject to management's discretion.

Dividends

We have never paid any cash dividends on our common stock. The Board of Directors presently intends to retain all earnings for use in our business. Any future determination as to payment of dividends will depend upon our financial condition and results of operations and such other factors as the Board of Directors deems relevant. Additionally, our ability to declare dividends should we decide to do so is restricted by the terms of our debt agreements.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

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

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

General

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

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

Critical Accounting Policies

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

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

Revenue Recognition

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

A portion of our revenue is derived from license agreements that entail the customization of FAAC's simulators to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with FASB ASC 605-35 based on the percentage of completion method over the period from signing of the license through to customer acceptance, as such simulators require significant modification or customization that takes time to complete. The percentage of completion is measured by monitoring progress using records of actual time incurred to date in the project compared with the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

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

We account for our other revenues from IES simulators in accordance with the provisions of FASB ASC 985-605. We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

We assess whether collection is probable at the time of the transaction based on a number of factors, including the customer's past transaction history and credit worthiness. If we determine that the collection of the fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon the receipt of cash.

Stock Based Compensation

We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of FASB ASC 505-50 using the modified prospective transition method. Under FASB ASC 505-50, stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

Allowance for Doubtful Accounts

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

Accounting for Income Taxes

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

We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under FASB ASC 740-10, involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. We do not provide for U.S. federal income taxes on the undistributed earnings of our foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be reinvested indefinitely.

We have indefinitely-lived intangible assets consisting of trademarks, workforce, and goodwill. Pursuant to FASB ASC 350-10, these indefinitely-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these indefinitely-lived intangible assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a “naked tax credit.” This deferred tax liability could remain on our balance sheet indefinitely unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

Due to the fact that the aforementioned deferred tax liability could have an indefinite life, it should not be netted against our deferred tax assets (which primarily relate to net operating loss carryforwards) when determining the required valuation allowance. Doing so would result in the understatement of the valuation allowance and related deferred income tax expense.

On January 1, 2007, we adopted the provisions of the FASB ASC 740-10. FASB ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. We must determine whether it is “more-likely-than-not” that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. Uncertain tax positions require determinations and estimated liabilities to be made based on provisions of the tax law which may be subject to change or varying interpretation. If our determinations and estimates prove to be inaccurate, the resulting adjustments could be material to its future financial results.

In addition, we operate within multiple taxing jurisdictions and may be subject to audits in these jurisdictions. These audits can involve complex issues that may require an extended period of time for resolution. In management’s opinion, adequate provisions for income taxes have been made.

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2009, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

As of December 31, 2009, we had recorded goodwill of $32.3 million. Under FASB ASC 350-10, goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests, and tests between annual tests in certain circumstances, based on estimated fair value in accordance with FASB ASC 350-10, and written down when impaired.

We determine fair value using a discounted cash flow analysis. This type of analysis requires us to make assumptions and estimates regarding industry economic factors and the profitability of future business strategies. 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. It is our policy to conduct impairment testing based on our current business strategy in light of present industry and economic conditions, as well as future expectations. In assessing the recoverability of our goodwill, we may be required to make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. This process is subjective and requires judgment at many points throughout the analysis. If our estimates or their related assumptions change in subsequent periods or if actual cash flows are below our estimates, we may be required to record impairment charges for these assets not previously recorded.

We completed our annual goodwill impairment review using the financial results as of the quarter ended June 30, 2009. Although the cumulative book value of our reporting units exceeded our market value as of the impairment review, management nevertheless determined that the fair value of the respective reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill. Several factors contributed to this determination:

- The long term horizon of the valuation process versus a short term valuation using current market conditions;
- The valuation by individual business segments versus the market share value based on our company as a whole; and
- The fact that our stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in our securities was not acting as an informationally efficient reflection of all known information regarding us.

In view of the above factors, management felt that in the current market our stock was undervalued, especially when compared to the estimated future cash flows of the underlying entities.

Other Intangible Assets

Other intangible assets are amortized to the Statement of Operations over the period during which benefits are expected to accrue, currently estimated at two to ten years.

The determination of the value of such intangible assets requires us to make assumptions regarding future business conditions and operating results in order to estimate future cash flows and other factors to determine the fair value of the respective assets. If these estimates or the related assumptions change in the future, we could be required to record additional impairment charges.

Contingencies

We are from time to time involved in legal proceedings and other claims. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. We have not made any material changes in the accounting methodology used to establish our self-insured liabilities during the past three fiscal years.

A determination of the amount of reserves required, if any, for any contingencies are made after careful analysis of each individual issue. The required reserves may change due to future developments in each matter or changes in approach, such as a change in the settlement strategy in dealing with any contingencies, which may result in higher net loss.

If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material.

Warranty Reserves

Upon shipment of products to our customers, we provide for the estimated cost to repair or replace products that may be returned under warranty. Our warranty period is typically twelve months from the date of shipment to the end user customer. For existing products, the reserve is estimated based on actual historical experience. For new products, the warranty reserve is based on historical experience of similar products until such time as sufficient historical data has been collected on the new product. Factors that may impact our warranty costs in the future include our reliance on our contract manufacturer to provide quality products and the fact that our products are complex and may contain undetected defects, errors or failures in either the hardware or the software.

Functional Currency

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

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

Executive Summary

Overview of Results of Operations

We incurred operating losses for the years ended December 31, 2009 and 2008. While we expect to continue to derive revenues from the sale of products that we manufacture and the services that we provide, there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis.

A portion of our operating loss during 2009 and 2008 arose as a result of non-cash charges. These charges were primarily related to our acquisitions, financings and issuances of restricted shares and options to employees. To the extent that we continue certain of these activities during 2010, we would expect to continue to incur such non-cash charges in the future.

ACQUISITIONS

In acquisition of subsidiaries, part of the purchase price is allocated to intangible assets and goodwill. Amortization of intangible assets related to acquisition of subsidiaries is recorded based on the estimated expected life of the assets. Accordingly, for a period of time following an acquisition, we incur a non-cash charge related to amortization of intangible assets in the amount of a fraction (based on the useful life of the intangible assets) of the amount recorded as intangible assets. Such amortization charges continued during 2009. We are required to review intangible assets for impairment whenever events or changes in circumstances indicate that carrying amount of the assets may not be recoverable. If we determine, through the impairment review process, that intangible asset has been impaired, we must record the impairment charge in our statement of operations.

In the case of goodwill, the assets recorded as goodwill are not amortized; instead, we are required to perform an annual impairment review. If we determine, through the impairment review process, that goodwill has been impaired, we must record the impairment charge in our statement of operations.

As a result of the application of the above accounting rule, we incurred non-cash charges for amortization of intangible assets in 2009 and 2008 in the amount of $1.5 million and $1.7 million, respectively.

FINANCINGS AND ISSUANCES OF RESTRICTED SHARES, OPTIONS AND WARRANTS

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

During 2009 and 2008, we issued restricted shares to certain of our employees and to our directors. These shares were issued as stock bonuses or were the required annual grant to directors, and are restricted for a period of up to three years from the date of issuance. Relevant accounting rules provide that the aggregate amount of the difference between the purchase price of the restricted shares (in this case, generally zero) and the market price of the shares on the date of grant is taken as a general and administrative expense, amortized over the life of the period of the restriction.

As a result of the application of the above accounting rules, we incurred non-cash charges related to stock-based compensation in 2009 and 2008 in the amount of $849,000 and $1.0 million, respectively.

As a result of options granted to employees and the adoption of FASB ASC 505-50, we incurred non-cash charges related to stock-based compensation in 2009 and 2008 in the amount of $0 and $68,000, respectively.

During the third quarter of 2008 and pursuant to the terms of a Securities Purchase Agreement dated August 14, 2008, we issued and sold to a group of institutional investors 10% senior convertible notes in the aggregate principal amount of $5.0 million due August 15, 2011. These notes are convertible at any time prior to August 15, 2011 at a conversion price of $2.24 per share. As part of our analysis of the convertible debt and related warrants, we reviewed and followed the guidance of FASB ASC 718-10, ASC 815-40-15, ASC 470-20-30 and ASC 105-10-05.

As part of the securities purchase agreement, we issued to the purchasers of our 10% senior convertible notes due August 15, 2011, warrants to purchase an aggregate of 558,036 shares of common stock at any time prior to August 15, 2011 at a price of $2.24 per share. The warrants were classified in 2008 as equity based on relative fair value. The relative fair value of these warrants was determined in 2008 using the Black-Scholes pricing model, assuming a risk-free interest rate of 2.78%, a volatility factor 75%, dividend yields of 0% and a contractual life of 3.0 years.

In connection with the original accounting for these convertible notes, we recorded a deferred debt discount on the balance sheet of $412,000 in 2008. The beneficial conversion feature and the discount arising from fair value allocation of the warrants according to FASB ASC 470-20-25 is being amortized from the date of issuance to the stated redemption date – August 15, 2011.

On January 1, 2009 we adopted FASB ASC 815-40-15, "Determining Whether an Instrument is Indexed to an Entity's Own Stock." FASB ASC 815-40-15 requires us to re-evaluate the warrants issued with the convertible notes and to also re-evaluate the embedded conversion option and embedded put options within the notes to determine if the previous accounting for these items would change. Upon this re-evaluation, we were required to reclassify the warrants along with the value of the embedded conversion feature from equity to a derivative liability. The embedded put options remained classified as derivative liabilities. We again used the Black-Scholes valuation model to determine the value of the warrants, the value of the embedded conversion feature and the value of the embedded put options associated with the convertible notes as of January 1, 2009. In accordance with the guidance of FASB ASC 815-40-15, a cumulative adjustment increasing January 1, 2009 retained earnings by $1.3 million was made in the first quarter to reflect this new accounting. We re-valued this amount in the third quarter of 2009 based on a revised valuation of the derivative liability. This resulted in a debt discount balance in the amount of approximately $202,000, which is included in Long Term Debt on the balance sheet, and a revised cumulative adjustment to retained earnings of $471,000.

On December 31, 2009, we revalued these warrants, their embedded conversion option and their embedded put options. The year to date financial expense associated with this transaction is approximately $342,000. The table below lists the variables used in the Black-Scholes calculation and the resulting values.

Variables	January 1, 2009	December 31, 2009
Stock price	$ 0.41	$ 1.70
Risk free interest rate	1.00%	1.70%
Volatility	81.40%	79.85%
Dividend yield	0.00%	0.00%
Contractual life	2.6 years	1.6 years
Values	**January 1, 2009**	**December 31, 2009**
Warrants	$ 29,171	$ 298,570
Conversion option	8,013	88,156
Puts	14,997	7,371
Total value	$ 52,181	$ 394,097
Change in value – charged to financial expense		$ (341,946)

Principal payments are due on the convertible notes as follows:

Year	Amount
2010	$ 1,818,180
2011	1,363,640
	$ 3,181,820

During 2009 and 2008, we recorded expenses of approximately $270,000 and $52,000, respectively, attributable to amortization related to warrants issued to the holders of convertible notes.

Concurrent with the Securities Purchase Agreement dated August 14, 2008, we purchased a $2.5 million Senior Subordinated Convertible Note from an unaffiliated company, DEI Services Corporation ("DEI"). This 10% Senior Subordinated Convertible Note (the "DEI Note") is due December 31, 2009. The DEI Note is convertible at maturity at our option into such number of shares of DEI's common stock, no par value per share, as shall be equal at the time of conversion to twelve percent (12%) of DEI's outstanding common stock. In the third quarter of 2009, we wrote down the value of the DEI Note by $500,000, to $2.0 million.

Interest on the outstanding principal amount of the DEI Note commenced accruing on the issuance date and is payable quarterly, in arrears. The issuer has been paying interest as required under the terms of the DEI Note, but did not pay the principal amount when due. We have discontinued accruing interest on the DEI Note due to the provision on the DEI Note recorded this quarter. Interest on the DEI Note will be recognized as a reduction of financial expenses and will be shown on an accrual basis. Related fees and costs will be recorded as general and administrative expense.

See also "Recent Developments," below.

Overview of Operating Performance and Backlog

Overall, our net loss before earnings from an affiliated company and tax expenses for 2009 was $2.2 million on revenues of $74.5 million, compared to a net loss of $2.4 million on revenues of $68.9 million during 2008. As of December 31, 2009, our overall backlog totaled $55.5 million.

In our Training and Simulation Division, revenues increased from approximately $36.0 million in 2008 to $39.2 million in 2009. As of December 31, 2009, our backlog for our Training and Simulation Division totaled $31.2 million.

In our Armor Division, revenues decreased from approximately $17.7 million in 2008 to approximately $17.5 million in 2009. As of December 31, 2009, our backlog for our Armor Division totaled $10.5 million.

In our Battery and Power Systems Division, revenues increased from approximately $15.2 million in 2008 to approximately $17.8 million in 2009. As of December 31, 2009, our backlog for our Battery and Power Systems Division totaled $13.8 million.

Overview of Operating Performance and Backlog

In February of 2009, we authorized, for a period of one year, the repurchase in the open market or in privately negotiated transactions of up to $1 million of our common stock. Pursuant to this plan, through December 31, 2009 we have repurchased 447,358 shares of our common stock for $563,556 ($554,099 net of commissions), all of which was purchased after April 1, 2009. Shares repurchased are carried on our books as treasury stock. At December 31, 2009, we had remaining authorization for the repurchase of up to $445,901 in shares of our common stock. The repurchase program is subject to the discretion of our management.

Recent Developments

DEI NOTE

In the third quarter of 2009 DEI repaid a portion of their internal shareholder loans, which was a violation of the DEI Note covenants with us. Because of this, we agreed in October of 2009 to amend the DEI Note to provide that the interest rate on the DEI Note would be increased to 15% and would be payable through the payment date. In the event that the DEI Note is not paid in full at maturity, the DEI Note will be convertible into a minimum of 20% of DEI's then outstanding common stock, or more under certain circumstances.

In November of 2009 DEI brought in a new investor that was prepared to provide DEI with additional working capital, but only if we agreed to step aside and accept a $500,000 discount on the DEI Note and waive our associated rights of first refusal and conversion. In view of the possibility that DEI would seek an extension of the DEI Note, we decided to enable DEI to bring in the new investor and thereby be able to pay the DEI Note on time, albeit at a discount. We accordingly wrote down the value of the DEI Note by $500,000, to $2.0 million and charged the associated expense to other income (expense) on the statement of operations. Inasmuch as the new investor's investment did not close, we retain all our rights under the DEI Note, including our right to be paid the full amount of the DEI Note and its conversion option and right of first refusal.

We declared a default on the DEI Note when it was not paid pursuant to its terms at the end of December 2009. We are presently prohibited from bringing suit to collect this note pursuant to the terms of a subordination agreement with DEI's senior lender. However, we are maintaining communication with DEI, and we continue to believe that DEI's anticipated earnings and cash flow will enable the DEI Note to be paid, albeit late. Interest on the DEI Note has been paid by DEI through November 15, 2009 and we expect DEI to continue to make timely interest payments on the DEI Note.

Results of Operations

Preliminary Note

SUMMARY

Following is a table summarizing our results of operations for the years ended December 31, 2008 and 2007, after which we present a narrative discussion and analysis:

	Year Ended December 31, 2009	Year Ended December 31, 2008
Revenues:		
Training and Simulation Division	$ 39,206,173	$ 36,032,703
Armor Division	17,507,298	17,762,439
Battery and Power Systems Division	17,820,980	15,153,827
	$ 74,534,451	$ 68,948,969
Cost of revenues:		
Training and Simulation Division	$ 24,568,708	$ 22,017,653
Armor Division	14,517,491	15,932,478
Battery and Power Systems Division	15,328,722	12,227,778
	$ 54,414,921	$ 50,177,909
Research and development expenses:		
Training and Simulation Division	$ 569,984	$ 797,112
Armor Division	506,838	247,462
Battery and Power Systems Division	249,933	613,094
	$ 1,326,755	$ 1,657,668
Sales and marketing expenses:		
Training and Simulation Division	$ 3,387,993	$ 3,232,367
Armor Division	782,937	754,645
Battery and Power Systems Division	697,568	712,858
	$ 4,868,498	$ 4,699,870
General and administrative expenses:		
Training and Simulation Division	$ 4,651,130	$ 4,068,614
Armor Division	1,588,973	1,590,549
Battery and Power Systems Division	1,079,063	1,239,288
All Other	4,979,429	7,195,313
	$ 12,298,595	$ 14,093,764
Amortization of intangible assets:		
Training and Simulation Division	$ 936,212	$ 1,212,958
Armor Division	13,350	13,350
Battery and Power Systems Division	509,240	509,240
	$ 1,458,802	$ 1,735,548
Escrow adjustment:		
All Other	$ –	$ (1,448,074)
	$ –	$ (1,448,074)
Operating profit (loss):		
Training and Simulation Division	$ 5,092,146	$ 4,703,999
Armor Division	97,709	(776,045)
Battery and Power Systems Division	(43,546)	(148,431)
All Other	(4,979,429)	(5,747,239)
	$ 166,880	$ (1,967,716)

	Year Ended December 31, 2009	Year Ended December 31, 2008
Other income:		
Training and Simulation Division	$ 31,591	$ 34,714
Armor Division	53,778	63,099
Battery and Power Systems Division	293	27
All Other	–	325,043
	$ 85,662	$ 422,883

	Year Ended December 31, 2009	2008
Allowance for settlements:		
All Other	$ 1,250,000	$ –
	$ 1,250,000	$ –
Financial expense:		
Training and Simulation Division	$ 1,342	$ 195
Armor Division	214,042	357,517
Battery and Power Systems Division	70,819	313,671
All Other	965,182	142,706
	$ 1,251,385	$ 814,089
Tax expenses (credits):		
Training and Simulation Division	$ 183,621	$ 68,608
Armor Division	(25,674)	58,147
Battery and Power Systems Division	28,926	100,113
All Other	618,093	800,000
	$ 804,966	$ 1,026,868
Loss from affiliated company:		
Training and Simulation Division	$ –	$ (352,166)
Armor Division	–	(100,000)
	$ –	$ (452,166)
Net income (loss):		
Training and Simulation Division	$ 4,938,774	$ 4,317,744
Armor Division	(36,881)	(1,228,610)
Battery and Power Systems Division	(142,998)	(562,188)
All Other	(7,812,704)	(6,364,902)
	$ (3,053,809)	$ (3,837,956)

Fiscal Year 2009 compared to Fiscal Year 2008

Revenues. During 2009, we (through our subsidiaries) recognized revenues as follows:

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

Revenues for 2009 totaled $74.5 million, compared to $68.9 million in 2008, an increase of $5.6 million, or 8.1%. This increase was primarily attributable to the following factors:

- Increased revenues from our Training and Simulation Division ($3.2 million more in 2009 versus 2008), primarily due to an increase in sales of military vehicle simulators.
- Increased revenues from our Battery and Power Systems Division ($2.6 million more in 2009 versus 2008), primarily due to increased military and commercial battery sales at Epsilor and EFL.

In 2009, revenues were $39.2 million for the Training and Simulation Division (compared to $36.0 million in 2008, an increase of $3.2 million, or 8.8%, due primarily to increased sales of military vehicle simulators); $17.5 million for the Armor Division (compared to $17.7 million in 2008, a decrease of $255,000, or 1.4%); and $17.8 million for the Battery and Power Systems Division (compared to $15.2 million in 2008, an increase of $2.6 million, or 17.6%, due primarily to increased sales of our battery products at Epsilor and EFL).

Cost of revenues. Cost of revenues totaled $54.4 million during 2009, compared to $50.2 million in 2008, an increase of $4.2 million, or 8.4%, due primarily to increased sales in our Training and Simulation and our Battery and Power Systems Divisions. Total cost of revenues and cost of revenues as a percentage of revenue also increased in each division due to several factors, including price increases in raw materials, increased labor costs and the production of new products.

Cost of revenues for our three divisions during 2009 were $24.6 million for the Training and Simulation Division (compared to $22.0 million in 2008, an increase of $2.6 million, or 11.6%, due to increased revenues and elevated material and labor costs); $14.5 million for the Armor Division (compared to $15.9 million in 2008, a decrease of $1.4 million, or 8.9%, due primarily to increased operating efficiencies, including reduced labor costs, in the production of the "David" Armored Vehicle); and $15.3 million for the Battery and Power Systems Division (compared to $12.2 million in 2008, an increase of $3.1 million, or 25.4%, due primarily to increased materials and labor associated with improved revenues at Epsilor and EFL; margins were also impacted by newly developed products).

Research and development expenses. Research and development expenses for 2009 were $1.3 million, compared to $1.7 million during 2008, a decrease of $331,000, or 20.0%, due primarily to reduced expenses in the amount of $590,000 in our Battery and Power Systems Division and our Training and Simulation Division, partially offset by increased expenses of $259,000 in our Armor Division for new product development, including our new Tiger platform.

Selling and marketing expenses. Selling and marketing expenses for 2009 were $4.9 million, compared to $4.7 million 2008, an increase of $169,000, or 3.6%, due primarily to increased revenues in the Training and Simulation Division and their associated sales and marketing expenses.

General and administrative expenses. General and administrative expenses for 2009 were $12.3 million, compared to $14.1 million in 2008, a decrease of $1.8 million, or 12.7%. This decrease was primarily attributable to a reduction of corporate expenses and 2008 acquisition expenses of $736,000. The decrease in expenses was offset by an increase in legal expenses in the Training and Simulation Division.

Amortization of intangible assets. Amortization of intangible assets totaled $1.5 million in 2009, compared to $1.7 million in 2008, a decrease of $277,000, or 15.9%, due to intangible assets in our Training and Simulation Division that are now fully amortized.

Escrow adjustment – credit. An escrow adjustment credit of $1.4 million in 2008 represents the first quarter 2008 final adjustment to operating expenses resulting from the completion of an escrow arbitration. This was a contingent earnout obligation that was identified by us when AoA was purchased and there will be no further adjustments to this amount.

Allowance for settlements. Allowances of $1.3 million were expensed in 2009 for pending activity in two areas. In the third quarter of 2009 the value of the DEI Note was written down by $500,000, to $2.0 million, and in the fourth quarter of 2009 we recorded an allowance in the amount of $750,000 relating to a potential adverse judgment in the litigation between our AoA subsidiary (which has since been merged into MDT) and NAVAIR.

Financial expenses, net. Financial expenses totaled approximately $1.3 million in 2009 compared to $814,000 in 2008, an increase of $437,000, or 53.7%. The difference was primarily due to increased expenses relating to our debt discount and for the mark-to-market adjustment related to our convertible debt.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2009 and, accordingly, no provision for income taxes was recorded for these losses. With respect to some of our subsidiaries that operated at a net profit during 2009, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of $805,000 in tax expenses in 2009, compared to $1.0 million in tax expenses in 2008, mainly due to state and local taxes along with the required adjustment of taxes due to the deduction of goodwill for U.S. federal taxes, which totaled $560,000 in 2009, as compared to $565,000 in 2008.

Net loss. Due to the factors cited above, net loss decreased to $3.1 million in 2009 from $3.8 million in 2008, a difference of $784,000, or 20.4%.

Liquidity and Capital Resources

As of December 31, 2009, we had $1.9 million in cash and $2.0 million in restricted cash, as compared to at December 31, 2008, when we had $4.3 million in cash, $382,000 in restricted cash and $49,000 in available-for-sale marketable securities. Our cash balances were impacted at year end due to $1.9 million in expenditures for the purchase of inventory and materials relating to our CaPost contract in our FAAC subsidiary. We also had $5.9 million available in unused bank lines of credit with our main bank, under a $10.0 million credit facility under our FAAC subsidiary, which is secured by our assets and the assets of our other subsidiaries and guaranteed by us. There was $2.6 million of available credit on the primary line at year end based on our borrowing base calculations.

We used available funds in 2009 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We purchased approximately $1.2 million of fixed assets during 2009 and also received fixed asset grants of approximately $260,000 that was credited to fixed assets at the then-current exchange rate. Our net fixed assets amounted to $4.6 million as at year end.

Net cash provided by operating activities for 2009 was $2.0 million, and net cash used in operating activities for 2008 was $(677,000), an increase of $2.7 million. This increase in cash provided was primarily the result of changes in working capital.

Net cash used in investing activities for 2009 and 2008 was $3.1 million and $2.3 million, respectively, an increase of $753,000. This change was primarily the result of the increase in restricted cash and additions to capitalized software, along with the acquisition activities, convertible loan and the escrow settlement that took place in 2008.

Net cash provided by (used in) financing activities for 2009 and 2008 was $(1.4) million and $3.9 million, respectively, an increase of $5.2 million, primarily due to the $5.0 million note purchased in 2008.

As of December 31, 2009, we had approximately $4.1 million in bank debt and $4.2 million in long-term debt outstanding.

Subject to all of the reservations regarding "forward-looking statements" set forth above, we believe that our present cash position, anticipated cash flows from operations and lines of credit should be sufficient to satisfy our current estimated cash requirements through the remainder of the year. In this connection, we note that from time to time our working capital needs are partially dependent on our subsidiaries' lines of credit.

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

Effective Corporate Tax Rate

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2009 and 2008, and accordingly no provision for income taxes was required. With respect to some of our U.S. subsidiaries that operated at a net profit during 2009, we were able to offset federal taxes against our net operating loss carryforward, which amounted to approximately $35.0 million as of December 31, 2009. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. With respect to certain of our Israeli subsidiaries that operated at a net profit during 2009, we were unable to offset their taxes against our net operating loss carryforward, and we are therefore exposed to Israeli taxes, at a rate of up to 26% in 2009 (less, in the case of companies that have "approved enterprise" status as discussed in Note [14.b.] to the Notes to Financial Statements). We also set up a tax liability for the impact of the deductions taken for goodwill.

As of December 31, 2009, we had a U.S. net operating loss carryforward of approximately $25.1 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2010 through 2026, and foreign net operating and capital loss carryforwards of approximately $105.7 million, which are available indefinitely to offset future taxable income under certain circumstances.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2009, not including trade payables and other accounts payable:

	Payment Due by Period				
Contractual Obligations	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt	$ 4,172,250	$ 1,902,097	$ 1,320,052	$ 77,670	$ 872,431
Short-term debt*	$ 4,074,890	$ 4,074,890	$ –	$ –	$ –
Operating lease obligations**	$ 3,402,504	$ 806,483	$ 1,056,932	$ 669,700	$ 869,389
Capital lease obligations	$ 124,318	$ 64,961	$ 58,856	$ 502	$ –
Severance obligations***	$ 4,985,011	$ –	$ 4,985,011	$ –	$ –

* Primarily in short-term bank debt.

** Includes operating lease obligations related to rent.

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

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2009, our management, including the principal executive officer and principal financial officer, evaluated our disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in our periodic reports that we file with the SEC. These disclosure controls and procedures are intended to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers, by other of our employees, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Any system of controls and procedures, no matter how well designed and operated, can at best provide only reasonable assurance that the objectives of the system are met and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Our controls and procedures are intended to provide only reasonable, not absolute, assurance that the above objectives have been met.

Based on their evaluation as of December 31, 2009, our principal executive officer and principal financial officer were able to conclude that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

We will continue to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and correct any deficiencies that we may discover in the future. Our goal is to ensure that our senior management has timely access to all material financial and non-financial information concerning our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to modify our disclosure controls and procedures.

Management's Report on Internal Control Over Financial Reporting

Our management, including our principal executive and financial officers, is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Our management has evaluated the effectiveness of our internal controls as of the end of the period covered by this Annual Report on Form 10-K for the year ended December 31, 2009. In making our assessment of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission in *Internal Control – Integrated Framework*.

Based on management's assessment and these criteria, our management concluded that our internal control over financial reporting was effective as of December 31, 2009.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

Changes in Internal Controls Over Financial Reporting

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

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Arotech Corporation,
Ann Arbor, Michigan:

We have audited the accompanying consolidated balance sheets of Arotech Corporation as of December 31, 2009 and 2008 and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the years then ended. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedules. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arotech Corporation and subsidiaries at December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 13 to the consolidated financial statements, the Company changed its method of accounting for warrants and the conversion option related to convertible notes due to the adoption of new accounting guidance regarding *Determining Whether an Instrument is Indexed to an Entity's Own Stock.*

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

Grand Rapids, Michigan	/s/ BDO Seidman, LLP
March 31, 2010	BDO Seidman, LLP

In U.S. dollars

	December 31, 2009	December 31, 2008
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,901,525	$ 4,301,359
Restricted cash	1,997,165	381,586
Available for sale marketable securities	–	49,204
Trade receivables (net of allowance for doubtful accounts in the amount of $47,000 and $19,000 as of December 31, 2009 and 2008, respectively)	14,010,974	19,346,084
Unbilled receivables	4,142,107	4,769,264
Other accounts receivable and prepaid expenses	2,825,202	3,625,955
Inventories	12,335,037	9,678,960
Total current assets	37,212,010	42,152,412
LONG TERM ASSETS:		
Deferred tax assets	41,405	72,114
Severance pay fund	3,447,884	2,888,867
Other long term receivables	395,456	463,780
Property and equipment, net	4,624,833	5,058,263
Investment in affiliated company	67,018	40,987
Other intangible assets, net	6,025,600	6,867,873
Goodwill	32,303,673	32,250,503
Total long term assets	46,905,869	47,642,387
Total assets	$ 84,117,879	$ 89,794,799

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31, 2009	December 31, 2008
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 5,149,243	$ 9,664,558
Other accounts payable and accrued expenses	6,239,436	5,858,959
Current portion of capitalized leases	45,911	62,833
Current portion of long term debt	1,902,097	1,861,187
Short term bank credit	4,074,890	3,607,890
Deferred revenues	4,434,093	3,789,020
Total current liabilities	21,845,670	24,844,447
LONG TERM LIABILITIES		
Accrued severance pay	4,985,011	5,161,448
Long term portion of capitalized leases	52,021	122,090
Long term debt	2,270,152	3,866,727
Deferred tax liability	2,990,000	2,430,000
Other long term liabilities	555,220	146,738
Total long-term liabilities	10,852,404	11,727,003
STOCKHOLDERS' EQUITY:		
Share capital –		
Common stock – $0.01 par value each;		
Authorized: 50,000,000 shares and 250,000,000 shares as of December 31, 2009 and 2008, respectively; Issued and outstanding: 14,405,948 shares and 13,637,639 shares as of December 31, 2009 and 2008, respectively	144,060	136,377
Preferred shares – $0.01 par value each		
Authorized: 1,000,000 shares as of December 31, 2009 and 2008; No shares issued and outstanding as of December 31, 2009 and 2008	–	–
Additional paid-in capital	220,481,911	220,124,075
Accumulated deficit	(169,788,022)	(167,205,514)
Notes receivable from stockholders	(954,647)	(1,357,788)
Accumulated other comprehensive income	1,536,503	1,526,199
Total stockholders' equity	51,419,805	53,223,349
Total liabilities and stockholders' equity	$ 84,117,879	$ 89,794,799

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

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

	December 31, 2009	December 31, 2008
Revenues	$ 74,534,451	$ 68,948,969
Cost of revenues, exclusive of amortization of intangibles	54,414,921	50,177,909
Research and development	1,326,755	1,657,668
Selling and marketing expenses	4,868,498	4,699,870
General and administrative expenses	12,298,595	14,093,764
Amortization of intangible assets and capitalized software	1,458,802	1,735,548
Escrow adjustment	–	(1,448,074)
Total operating costs and expenses	74,367,571	70,916,685
Operating profit (loss)	166,880	(1,967,716)
Other income	85,662	422,883
Allowance for settlements	(1,250,000)	–
Financial expenses, net	(1,251,385)	(814,089)
Total other expenses	(2,415,723)	(391,206)
Loss before earnings from affiliated company, and income tax expenses	(2,248,843)	(2,358,922)
Loss from affiliated company	–	(452,166)
Income tax expenses	(804,966)	(1,026,868)
Net loss	$ (3,053,809)	$ (3,837,956)
Basic and diluted net loss per share	$ (0.24)	$ (0.30)
Weighted average number of shares used in computing basic and diluted net loss per share	12,777,867	12,605,786

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (as restated; see Note 19)
In U.S. dollars

	Common stock							
	Shares	Amount	Additional paid-in capital	Accumulated deficit	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
Balance as of January 1, 2008	13,544,819	$ 135,448	$ 218,551,110	$ (163,367,558)	$(1,333,833)	$ 1,501,441	$ –	$ 55,486,608
Issuance of warrants	–	–	412,300	–	–	–	–	412,300
Stock based compensation	–	–	1,039,270	–	–	–	–	1,039,270
Restricted stock issued	38,472	385	(385)	–	–	–	–	–
Issuance of stock for acquisition	54,348	544	97,825	–	–	–	–	98,369
Interest accrued on notes receivable from shareholders	–	–	23,955	–	(23,955)	–	–	–
Other comprehensive income – foreign currency translation adjustment	–	–	–	–	–	23,103	23,103	23,103
Other comprehensive income – unrealized gain on available for sale marketable securities	–	–	–	–	–	1,655	1,655	1,655
Net loss	–	–	–	(3,837,956)	–	–	(3,837,956)	(3,837,956)
Total comprehensive loss	–	–	–	–	–	–	$ (3,813,198)	–
Balance as of December 31, 2008	13,637,639	$ 136,377	$ 220,124,075	$ (167,205,514)	$ (1,357,788)	$ 1,526,199		$ 53,223,349

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

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

	Common stock		Additional paid-in capital	Accumulated deficit	Notes receivable from stockholders	Accumulated other comprehensive income (loss)	Total comprehensive income (loss)	Total stockholders' equity
	Shares	Amount						
Balance as of December 31, 2008	13,637,639	$ 136,377	$ 220,124,075	$ (167,205,514)	$(1,357,788)	$ 1,526,199	$ –	$ 53,223,349
ASC 815-40 cumulative adjustment	–	–	(412,300)	471,301	–	–	–	59,001
Balance as of January 1, 2009	13,637,639	$ 136,377	$ 219,711,775	$ (166,734,213)	$(1,357,788)	$ 1,526,199	$ –	$ 53,282,350
Treasury stock purchase and retirement	(447,358)	(4,474)	(559,082)	–	–	–	–	(563,556)
Conversion of convertible notes	220,017	2,200	453,044	–	–	–	–	455,244
Stock based compensation	–	–	849,272	–	–	–	–	849,272
Restricted stock issued	412,622	4,126	(4,126)	–	–	–	–	–
Forfeitures of prior stock awards	(19,712)	(197)	197	–	–	–	–	–
Issuance of stock in lieu of funding severance	602,740	6,028	433,972	–	–	–	–	440,000
Write-down of shareholder loans	–	–	(403,141)	–	403,141	–	–	–
Other comprehensive income – foreign currency translation adjustment	–	–	–	–	–	10,304	10,304	10,304
Net loss	–	–	–	(3,053,809)	–	–	(3,053,809)	(3,053,809)
Total comprehensive loss	–	–	–	–	–	–	$ (3,043,505)	–
Balance as of December 31, 2009	14,405,948	$ 144,060	$ 220,481,911	$ (169,788,022)	$ (954,647)	$ 1,536,503		$ 51,419,805

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

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

	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (3,053,809)	$ (3,837,956)
Adjustments required to reconcile net loss to net cash (used in) provided by operating activities:		
Loss from affiliated companies	–	452,168
Depreciation	1,260,458	1,246,238
Amortization of intangible assets and capitalized software costs	1,458,802	1,735,548
Amortization of debt discount	269,801	51,537
Increase in escrow receivable	–	(1,845,977)
Compensation related to shares issued to employees, consultants and directors	849,272	1,039,270
Adjustment to value of warrants and embedded features on the senior convertible notes	341,916	–
Capital loss from sale of property and equipment	(14,640)	(11,379)
Deferred tax expense	590,709	570,595
Allowances for settlements	1,250,000	–
Changes in operating assets and liabilities, excluding effect of business acquisition:		
Accrued (deferred) severance pay, net	(295,454)	234,390
Trade receivables	5,335,110	(4,570,057)
Other accounts receivable and prepaid expenses	369,077	234,402
Inventories	(2,656,077)	(1,760,946)
Unbilled receivables	627,157	(1,432,369)
Deferred revenues	645,073	885,854
Trade payables	(4,515,315)	5,420,310
Other accounts payable and accrued expenses	(442,130)	911,112
Net cash provided by (used in) operating activities	$ 2,019,950	$ (677,260)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment, net of investment grants received from the State of Israel	(896,972)	(1,191,822)
Convertible note purchased from unaffiliated entity	–	(2,500,000)
Additions to capitalized software development	(680,398)	–
Proceeds from escrow settlement	–	3,325,803
Acquisition of subsidiary, net of cash acquired	–	(1,037,884)
Acquisition of noncontrolling interest	–	(660,500)
Investment in affiliated company	(26,031)	(140,987)
Repayment of promissory notes related to acquisition of subsidiaries	–	(151,450)
Proceeds from sale of property and equipment	84,584	87,521
Proceeds from sales of marketable securities	49,947	–
Increase in restricted cash	(1,616,322)	(63,331)
Net cash provided by (used in) investing activities	$ (3,085,192)	$ (2,332,650)
FORWARD	$ (1,065,242)	$ (3,009,910)

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	2009	2008
FORWARD	$ (1,065,242)	$ (3,009,910)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of long term debt	(1,259,039)	(166,165)
Increase (decrease) in short term bank credit	467,000	(950,000)
Increase in long term debt	–	5,000,000
Purchase of treasury stock	(563,556)	–
Net cash provided by (used in) financing activities	(1,355,595)	3,883,835
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(2,420,837)	873,925
CASH ACCRETION (EROSION) DUE TO EXCHANGE RATE DIFFERENCES	21,003	(20,237)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	4,301,359	3,447,671
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	$ 1,901,525	$ 4,301,359
SUPPLEMENTARY INFORMATION ON NON-CASH AND OTHER TRANSACTIONS:		
Stock issued for acquisition	$ –	$ 100,000
Assets recorded for capital lease addition	$ –	$ 106,029
Interest paid during the period	$ 671,356	$ 455,051
Taxes on income paid during the period	$ 162,774	$ 333,144
Relative fair value of warrants issued in connection with convertible note	$ –	$ 412,300
Note conversion to common stock	$ 455,244	$ –
Write-off of non-recourse shareholder loans	$ 403,141	$ –
Issuance of stock in lieu of funding severance	$ 440,000	$ –

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

NOTE 1:– GENERAL

a. Corporate structure:

Arotech Corporation ("Arotech") and its wholly-owned subsidiaries (the "Company") provide defense and security products for the military, law enforcement and homeland security markets, including advanced zinc-air and lithium batteries and chargers, multimedia interactive simulators/trainers and lightweight vehicle armoring. The Company operates primarily through its wholly-owned subsidiaries FAAC Incorporated ("FAAC"), based in Ann Arbor, Michigan and Royal Oak, Michigan; MDT Protective Industries, Ltd. ("MDT"), based in Lod, Israel; MDT Armor Corporation ("MDT Armor"), based in Auburn, Alabama; Electric Fuel Battery Corporation ("EFB"), based in Auburn, Alabama; Electric Fuel Ltd. ("EFL"), based in Beit Shemesh, Israel; and Epsilor Electronic Industries, Ltd. ("Epsilor"), based in Dimona, Israel. The Company's former subsidiaries Armour of America Incorporated ("AoA") and Realtime Technologies, Inc. ("RTI") have been merged into MDT Armor and FAAC, respectively.

b. Acquisition of FAAC:

The Company had a contingent earnout obligation in an amount equal to the net income realized by the Company from certain specific programs that were identified by the Company and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. The $151,450 shown as promissory notes in the 2007 balance sheet is the portion of the 2006 earnout that was paid in equal installments that started in January 2007 and was fully paid in June 2008. The promissory note was non-interest bearing.

c. Acquisition of AoA:

The total purchase price consisted of $19,000,000 in cash, with additional possible earn-outs if AoA was awarded certain material contracts. In 2005 and 2007 the Company recorded impairments of goodwill and intangibles totaling $12.6 million. Additionally, in connection with the Company's acquisition of AoA, the Company had a contingent earnout obligation in an amount equal to the revenues AoA realized from certain specific programs that were identified by the Company and the seller of AoA ("Seller") as appropriate targets for revenue increases. As of December 31, 2006, the Company had reduced the $3.0 million escrow held by the Seller by approximately $1,520,000 for a putative claim against such escrow in respect of such earnout obligation.

On March 20, 2007, the Company filed a Demand for Arbitration with the American Arbitration Association against the Seller. In February 2008, the arbitration panel issued a decision denying the Seller's counterclaims in respect of the Company's earnout obligation, granting the Seller's counterclaim for $70,000 in compensation, and awarding the Company the entire $3.0 million escrow, along with $135,000 in attorneys' fees and interest of approximately $325,000. The net impact of the settlement was a gain to the Company of approximately $1.8 million, which included an escrow adjustment in the first quarter 2008 of $1.4 million and approximately $398,000 in interest and net legal fees. This award was paid to the Company in April 2008, and the time for the Seller to move to vacate or modify this award has now expired.

d. Purchase of the Noncontrolling Interest in MDT and MDT Armor

In January 2008, the Company purchased the minority shareholder's 24.5% interest in MDT Protective Industries Ltd. ("MDT") and his 12.0% interest in MDT Armor Corporation ("MDT Armor"), as well as settling all outstanding disputes regarding severance payments, in exchange for a total of $1.0 million that was paid in cash. The purchase was treated as a step acquisition using the purchase method of accounting. The Company evaluated the purchase price and identified $607,100 in goodwill and workforce intangibles with an indefinite life. The Company also identified $53,400 as an intangible asset related to its customer list with a useful life of four years. The remaining balance of $339,500 was expensed in the first quarter of 2008.

e. Acquisition of Realtime Technologies, Inc.

In February 2008 the Company's FAAC subsidiary acquired all of the outstanding stock of Realtime Technologies, Inc. (RTI), a privately-owned corporation headquartered in Royal Oak, Michigan, for a total of approximately $1,387,000, including $1,250,000 in cash, $100,000 in Company stock (54,348 shares) and approximately $37,000 in legal fees along with a contingent earnout of $250,000 that was earned in 2008 and recorded as compensation expense. RTI specializes in multi-body vehicle dynamics modeling and

In U.S. dollars

NOTE 1:– GENERAL (Cont.)

graphical simulation solutions. RTI's product portfolio provides FAAC with the opportunity to economically add new features to the driver training products marketed by FAAC.

RTI's operating results are included in the Company's Training and Simulation Division as of January 1, 2008 and the effect on operations was not material.

Listed below is the purchase price allocation:

Current assets acquired, net of liabilities	$ 433,389
Technology and patents - 7 year life	663,000
Trademark/trade names - 10 year life	28,000
Customer relationships - 10 year life	62,000
Goodwill - indefinite life	200,222
Equity value	$ 1,386,611

f. Impairment of goodwill and other intangible assets:

Goodwill is tested for impairment at least annually, and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reporting units with their carrying value. All of the Company's reporting units have goodwill subject to annual testing. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital.

In both 2009 and 2008, the Company evaluated all goodwill at mid-year and determined that there was no impairment.

The Company completed its annual goodwill impairment review using the financial results as of the quarter ended June 30, 2009. Although the cumulative book value of the Company's reporting units exceeded the Company's market value as of the impairment review, management nevertheless determined that the fair value of the respective reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill. Several factors contributed to this determination:

- The long term horizon of the valuation process versus a short term valuation using current market conditions;
- The valuation by individual business segments versus the market share value based on the Company as a whole; and
- The fact that the Company's stock is thinly traded and widely dispersed with minimal institutional ownership, and thus not followed by major market analysts, leading management to conclude that the market in the Company's securities was not acting as an informationally efficient reflection of all known information regarding the Company.

In view of the above factors, management felt that in the current market the Company's stock was undervalued, especially when compared to the estimated future cash flows of the underlying entities.

The Company's long-lived assets and amortizable identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

g. Related parties

The Company has had a consulting agreement with Sampen Corporation since 2005. Sampen is a New York corporation owned by members of the immediate family of one of the Company's executive officers, and this executive officer is an employee of both the Company and of Sampen. The term of this consulting agreement was extended automatically for additional term of two years until December 31, 2010, unless either Sampen or the Company terminates the agreement sooner.

NOTE 1:– GENERAL (Cont.)

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

During the years ended December 31, 2009 and 2008 the Company paid Sampen a total of $178,356 and $178,424, respectively.

On December 3, 1999, Robert S. Ehrlich purchased 8,928 shares of the Company's common stock out of the Company's treasury at the closing price of the Company's common stock on December 2, 1999. Payment was rendered by Mr. Ehrlich in the form of non-recourse promissory notes due in 2009 in the amount of $167,975, bearing simple annual interest at a rate of 2%, secured by the shares of common stock purchased and other shares of common stock previously held by him. As of December 31, 2008, the aggregate amount outstanding pursuant to these promissory notes from Mr. Ehrlich and a former employee with the same arrangement was $403,141, which was not repaid and was therefore written off to paid-in capital in the fourth quarter of 2009.

On February 9, 2000, Mr. Ehrlich exercised 9,404 stock options. Mr. Ehrlich paid the exercise price of the stock options and certain taxes that the Company paid on his behalf by giving the Company a non-recourse promissory note due in 2025 in the amount of $329,163, bearing annual interest at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, secured by the shares of the Company's common stock acquired through the exercise of the options and certain compensation due to Mr. Ehrlich upon termination. As of December 31, 2009, the aggregate amount outstanding pursuant to this promissory note was $452,995. Again, there is a former employee with the same arrangement.

On June 10, 2002, Mr. Ehrlich exercised 3,571 stock options. Mr. Ehrlich paid the exercise price of the stock options by giving the Company a non-recourse promissory note due in 2012 in the amount of $36,500, bearing simple annual interest at a rate equal to the lesser of (i) 5.75%, and (ii) 1% over the then-current federal funds rate announced from time to time, secured by the shares of the Company's common stock acquired through the exercise of the options. As of December 31, 2009, the aggregate amount outstanding pursuant to this promissory note was $46,593.

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 is generated in U.S. dollars. In addition, a substantial portion of the Company's 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 operates. Thus, the functional and reporting currency of the Company including 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, with resulting gains and losses reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Restricted cash:

Restricted cash is primarily invested in highly liquid deposits which are used as a security for the Company's performance guarantees at FAAC and MDT Armor.

f. Marketable securities:

The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Investment in trust funds are classified as available-for-sale and stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of income.

The Company sold all marketable securities and as of December 31, 2009 the balance was zero.

g. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence and for market prices lower than cost. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are made to write inventory down to its market value. In 2009 and 2008, the Company wrote off $12,000 and $155,000, respectively, of obsolete inventory, which has been included in the cost of revenues.

Cost is determined as follows:

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

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

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

h. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants received from the State of Israel for investments in fixed assets under the Investment Law. Investment grants of approximately $270,000 were received in 2009 and no investment grants were received during 2008.

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

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

	Depreciable life (in years)
Computers and related equipment	3 to 5
Motor vehicles	5 to 7
Office furniture and equipment	10
Machinery and equipment	10
Buildings	30
Land	Not depreciated
Leasehold improvements	Shorter of the term of the lease or the life of the asset
Demo inventory	5

i. Revenue recognition:

The Company is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. During 2009 and 2008, the Company recognized revenues as follows: (i) from the sale and customization of interactive training systems and from the maintenance services in connection with such systems (Training and Simulation Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery and Power Systems Division); and (iv) from the sale of lifejacket lights (Battery and Power Systems Division).

Revenues from products sold by the Battery and Power Systems Division and the Armor Division are recognized when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probable, and no further obligation remains.

Revenues from contracts in the Training and Simulation division that involve customization of the system to customer specific specifications are recognized using contract accounting on a percentage of completion method, in accordance with the "Input Method." The amount of revenue recognized is based on the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual time, materials and other costs incurred to date in the project compared to the total estimated project requirement. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract.

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

Revenues from simulators that do not require significant customization are recognized when persuasive evidence of an agreement exists, delivery has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectability is probable.

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

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

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

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

j. Right of return:

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

k. Warranty:

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

l. Research and development cost:

The Company capitalizes certain software development costs, subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon the completion of a working model or a detailed program design. Research and development costs incurred in the process of developing product improvements or new products are generally charged to expenses as incurred. Significant costs incurred by the Company between completion of the working model or a detailed program design and the point at which the product is ready for general release have been capitalized. Capitalized software costs will be amortized by the greater of the amount computed using: (i) the ratio that current gross revenues from sales of the software bears to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (two to five years). The Company assesses the net realizable value of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2009.

In 2009, the Training and Simulation division capitalized approximately $680,000 in software development costs that will be amortized on a straight-line method over 2 years, the useful life of the software.

m. Income taxes:

The Company accounts for income taxes under the liability method, whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and the tax basis 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 provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

n. Concentrations of credit risk:

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

The trade receivables of the Company are mainly derived from sales to customers located primarily in the United States and Israel along with the countries listed in footnote 16 c.. Management believes that credit risks are moderated by the diversity of its end customers and geographical sales areas. The Company performs ongoing credit evaluations of its customers' financial condition. An allowance for doubtful accounts is determined with respect to those accounts that the Company has determined to be doubtful of collection.

The Company's available-for-sale marketable securities have included investments in debentures of U.S. and Israeli corporations and state and local governments. Management believes that those corporations

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

and governments are institutions that are financially sound and that minimal credit risk exists with respect to these types of marketable securities. The Company sold all marketable securities and as of December 31, 2009 the balance was zero.

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

o. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year. Diluted net loss per share is computed based on the weighted average number of shares of common stock outstanding during each year, plus dilutive common stock equivalents related to outstanding stock options, non vested restricted stock, warrants and convertible debt. All common stock equivalents 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 common stock equivalents excluded from the calculations of diluted net loss per share was 1,387,014 and 958,881 for the years ended December 31, 2009 and 2008, respectively.

p. Accounting for stock-based compensation

Stock-based awards to employees are required to be recognized as compensation expense based on the calculated fair value on the date of grant. The Company determines the fair value using the Black-Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term.

The Company did not grant any options in 2008 or 2009. The Company assumed a 20% forfeiture rate on existing options for both years. The Company uses a 10% forfeiture rate for restricted stock and adjusts both forfeiture rates based on historical forfeitures.

q. Fair value of financial instruments:

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

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

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

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

r. Severance pay:

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

In addition, 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 of $2,160,428 for this special severance pay. As of December 31, 2009 and 2008 the unfunded severance pay in that regard amounted to $857,624 and $1,472,523, respectively.

Pursuant to the terms of the respective employment agreements between the Company and its Chief Executive Officer and its Chief Operating Officer, funds to secure payment of their respective contractual

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

severance amounts are to be deposited for their benefit, with payments to be made pursuant to an agreed-upon schedule. These funds continue to be owned by the Company, which benefits from all gains and bears the risk of all losses resulting from investments of these funds.

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

In April 2009, the Company, with the agreement of its Chief Executive Officer and its Chief Operating Officer, funded an additional portion of their severance security by means of issuing to them, in trust, restricted stock having a value (based on the closing price of the Company's stock on the Nasdaq Stock Market on the date on which the executives and the Company's board of directors agreed on this arrangement) of $440,000, a total of 602,740 shares. The Company agreed with the executives that the economic risk of gain or loss on these shares is to be borne by them. Should they leave the Company's employ under circumstances in which they are not entitled to their severance package (primarily, termination for Cause as defined in his employment agreement), these shares would be returned to the Company for cancellation and because of this, these shares are not included in the basic EPS calculation.

Severance expenses for the years ended December 31, 2009 and 2008 amounted to $61,107 and $202,627, respectively.

s. Advertising costs:

The Company records advertising costs as incurred. Advertising expense for the years ended December 31, 2009 and 2008 was approximately $87,955 and $100,347, respectively.

t. New accounting pronouncements:

In June 2009, the FASB issued ASU 2009-01, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles." The FASB Accounting Standards Codification is intended to be the source of authoritative GAAP and reporting standards as issued by the FASB. Its primary purpose is to improve clarity and use of existing standards by grouping authoritative literature under common topics. This Statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company adopted ASU 2009-01 in the third quarter of 2009 and has included references to the ASC within its consolidated financial statements.

In October 2009, the FASB issued ASU 2009-13, "Revenue Recognition (ASC 605) – Multiple-Deliverable Revenue Arrangements" and ASU 2009-14, "Software (ASC 985) – Certain Revenue Arrangements That Include Software Elements." ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: i) vendor-specific objective evidence ("VSOE") or ii) third-party evidence ("TPE"), before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. These new updates are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The Company is currently evaluating both the timing and the impact of the pending adoption of these ASU's on its consolidated financial statements.

In October 2009, the FASB issued ASU 2009-15, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing," which amends ASC Topic 470 and pro-

In U.S. dollars

NOTE 2:– SIGNIFICANT ACCOUNTING POLICIES (Cont.)

vides guidance for accounting and reporting for own-share lending arrangements issued in contemplation of a convertible debt issuance. At the date of issuance, a share-lending arrangement entered into on an entity's own shares should be measured at fair value in accordance with Topic 820 and recognized as an issuance cost, with an offset to additional paid-in capital. Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs. The amendments also require several disclosures including a description and the terms of the arrangement and the reason for entering into the arrangement. The effective dates of the amendments are dependent upon the date the share-lending arrangement was entered into and include retrospective application for arrangements outstanding as of the beginning of fiscal years beginning on or after December 15, 2009. The Company does not believe that the adoption of this standard will have any material impact on its financial position or results of operations.

u. Share repurchase:

In February 2009, the Company authorized, for a period of one year, the repurchase in the open market or in privately negotiated transactions of up to $1.0 million of the Company's common stock. Through December, 2009, the Company repurchased 447,358 shares for a total of $563,556. The repurchase program is subject to management's discretion.

The repurchase program is subject to management's discretion.

v. Reclassification:

Prior period amounts are reclassified to conform to the current period presentation.

NOTE 3: – RESTRICTED CASH

	December 31, 2009	December 31, 2008
Short-term:		
Deposits in connection with MDT projects	$ 380,165	$ 381,586
Deposits in connection with FAAC projects	1,617,000	–
Total cash	$ 1,997,165	$ 381,586

NOTE 4: – AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2009 and 2008:

	Cost		Unrealized gains		Estimated fair value	
	2009	2008	2009	2008	2009	2008
Available for sale marketable securities	$ –	$ 47,005	$ –	$ 2,199	$ –	$ 49,204

The marketable securities were sold in the fourth quarter of 2009.

NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31, 2009	December 31, 2008
Government authorities	$ 321,630	$ 114,090
Employees	62,643	45,458
Prepaid expenses	440,693	623,561
Loan to non-affiliated entity	2,000,000	2,531,250
Other	236	311,596
Total	$ 2,825,202	$ 3,625,955

In August 2008, the Company purchased a $2,500,000 10% Senior Subordinated Convertible Note from DEI Services Corporation ("DEI"), an unaffiliated company. This 10% Senior Subordinated Convertible Note (the "DEI Note") was due December 31, 2009. Interest was payable on a quarterly basis. The DEI Note is convertible at the Company's option into such number of shares of DEI's common stock, no par

In U.S. dollars

NOTE 5:– OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES (Cont.)

value per share, equal at the time of conversion to twelve percent (12%) of DEI's outstanding common stock.

In the third quarter of 2009 DEI repaid a portion of their internal shareholder loans, which was a violation of the DEI Note covenants with the Company. Because of this, the Company agreed in October of 2009 to amend the DEI Note to provide that the interest rate on the DEI Note would be increased to 15% and would be payable through the payment date. In the event that the DEI Note is not paid in full at maturity, the DEI Note will be convertible into a minimum of 20% of DEI's then outstanding common stock, or more under certain circumstances.

In November 2009, DEI brought in a new investor that was prepared to provide DEI with additional working capital, but only if the Company agreed to step aside and accept a $500,000 discount on the DEI Note and waive its associated rights of first refusal and conversion. In view of the possibility that DEI would seek an extension of the DEI Note, the Company decided to enable DEI to bring in the new investor and thereby be able to pay the DEI Note on time, albeit at a discount. The Company accordingly wrote down the value of the DEI Note in the third quarter of 2009 by $500,000, to $2.0 million and charged the associated expense to allowance for settlements on the statement of operations. When the new investor's investment did not close, the Company retained all its rights under the DEI Note, including its right to be paid the full amount of the DEI Note and its conversion option and right of first refusal.

The Company declared a default on the DEI Note when it was not paid pursuant to its terms at the end of December 2009. The Company is presently prohibited from bringing suit to collect this note pursuant to the terms of a subordination agreement with DEI's senior lender. However, the Company is maintaining communication with DEI, and the Company continues to believe that DEI's anticipated earnings and cash flow will enable the DEI Note to be paid, albeit late. Interest on the DEI Note has been paid by DEI through November 15, 2009 and the Company expects DEI to continue to make timely interest payments on the DEI Note.

Management has determined that the DEI Note, in the event of an impairment, would be valued using Level 2 inputs under FASB ASC 820-10, using inputs related to interest rates, term of the note and relative risk on similar notes available in the marketplace.

NOTE 6:– INVENTORIES

	December 31, 2009	December 31, 2008
Raw and packaging materials	$ 7,479,672	$ 6,798,662
Work in progress	3,943,073	2,251,734
Finished products	912,292	628,564
Total	$ 12,335,037	$ 9,678,960

NOTE 7:– PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31, 2009	December 31, 2008
Cost:		
Computers and related equipment	$ 2,293,941	$ 2,408,734
Motor vehicles	508,199	529,685
Office furniture and equipment	1,228,694	1,030,199
Machinery, equipment and installations	4,618,750	5,499,776
Buildings	1,172,072	1,172,072
Land	115,538	115,538
Leasehold improvements	1,047,208	973,360
Demo inventory	1,607,948	1,424,831
	$ 12,592,350	$ 13,154,195

In U.S. dollars

NOTE 7:– PROPERTY AND EQUIPMENT, NET (Cont.)

	December 31, 2009	December 31, 2008
Accumulated depreciation:		
Computers and related equipment	2,010,768	2,163,444
Motor vehicles	163,632	290,839
Office furniture and equipment	873,151	648,278
Machinery, equipment and installations	3,232,669	3,671,997
Buildings	85,150	55,097
Leasehold improvements	724,992	611,139
Demo inventory	877,155	655,138
	7,967,517	8,095,932
Property and equipment, net	$ 4,624,833	$ 5,058,263

b. Depreciation expense amounted to $1,260,458 and $1,246,238 for the years ended December 31, 2009 and 2008, respectively.

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

As for liens, see Note 11.d.

NOTE 8:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

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

	December 31, 2008	Additions	Adjustments (currency)	December 31, 2009
Simulation	$24,435,641	$ –	$ –	$ 24,435,641
Armor	1,799,393	–	10,146	1,809,539
Battery	6,015,469	–	43,024	6,058,493
Total	$32,250,503	$ –	$ 53,170	$ 32,303,673

b. Other intangible assets:

		December 31, 2009		December 31, 2008	
	Useful life	Cost	Net Book Value	Cost	Net Book Value
Technology	4-8 years	$ 7,068,000	$ 1,626,071	$ 7,068,000	$ 2,297,036
Capitalized software costs	1-3 years	2,401,387	674,699	1,720,991	100,408
Trademarks	10 years	28,000	22,400	28,000	25,200
Backlog/customer relationship	1-10 years	744,000	49,600	744,000	55,800
Covenants not to compete	5 years	99,000	–	99,000	–
Customer list	2-10 years	7,602,045	2,513,609	7,602,045	3,186,342
Certification	3 years	246,969	–	246,969	–
		18,189,401	$ 4,886,379	17,509,005	$ 5,664,786
Exchange differences		340,221		404,088	
Less - accumulated amortization		(13,303,022)		(11,844,220)	
Amortized cost		5,226,600		6,068,873	
Trademarks		799,000		799,000	
Net book value		$ 6,025,600		$ 6,867,873	

Subsequent to the 2004 purchase of AoA, the Company recorded an impairment charge in 2005 to fully impair related goodwill ($10.5 million) and intangible assets ($2.6 million). Additionally, due to an earnout on the same transaction, the Company recorded an additional $316,000 in goodwill in 2007 and immediately recorded an impairment of $316,000. The Company has not recorded any other goodwill impairment charges.

Amortization expense amounted to $1,458,802 and $1,735,548 for the years ended December 31, 2009 and 2008, respectively, including amortization of capitalized software costs of $106,105 and $342,408, respectively.

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

c. Estimated amortization expenses for the years ended:

Year ended December 31,		
2010	$	1,586,331
2011		1,642,753
2012		801,125
2013		725,455
2014 and forward		130,715
Total	$	4,886,379

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

NOTE 9:– SHORT-TERM BANK CREDIT AND LOANS

The Company has $10.7 million authorized in credit lines from certain banks, of which $675,000 is denominated in NIS and carries various approximate interest rates of prime rate + 4.3% and $10.0 million is denominated in U.S. dollars (the Company's primary line which expires in December 2010) and carries an interest rate of lender's prime rate + 1.5% which was 4.75% as of December 31, 2009. As of December 31, 2009, $4.1 million was borrowed under the Company's primary line, and an additional $1.3 million is committed to six letters of credit issued to customers and vendors of the Company. The Company has an additional $1.6 million letter of credit that does not impact the borrowing base as it is collateralized by $1.6 million in restricted cash. Approximately $2.6 million of credit on the primary line, based on the Company's borrowing base calculations, was available at year end.

These lines of credit are collateralized by the accounts receivable and inventory of the relevant subsidiary of the Company.

NOTE 10:– OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2009	2008
Employees and payroll accruals	$ 2,696,018	$ 1,557,628
Accrued vacation pay	711,373	675,142
Accrued expenses	1,744,469	1,759,873
Government authorities	107,832	333,390
Advances from customers	979,744	1,532,926
Total	$ 6,239,436	$ 5,858,959

NOTE 11:– COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

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. (Amounts due in respect of projects approved after year 1999 also bear interest at the Libor rate). EFL is obligated to pay royalties only on sales of products in respect of which OCS participated in their development. Should the project fail, EFL will not be obligated to pay any royalties or refund the grants.

Royalties paid or accrued for the years ended December 31, 2009 and 2008 to the OCS amounted to $19,832 and $11,821, respectively.

b. Lease commitments:

The Company rents facilities under various operating lease agreements, which expire on various dates through 2018. The minimum rental payments under non-cancelable operating leases are as follows:

In U.S. dollars

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

	December 31,
2010	$ 806,483
2011	532,797
2012	524,135
2013	347,085
2014	322,615
Thereafter	869,389
Total	$ 3,402,504

Total rent expenses for the years ended December 31, 2009 and 2008 were $835,370 and $805,518, respectively.

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

The table below details the original value, depreciation and net book value of the assets included.

Leased Assets	December 31, 2009	December 31, 2008
Equipment	$ 206,564	$ 355,561
Less: Accumulated depreciation	(85,058)	(179,429)
Net book value	$ 121,506	$ 176,132

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

Liabilities	December 31, 2009
Obligations under capital leases:	
Current	$ 64,961
Non-current	59,357
Total minimum payments	124,318
Less: Interest	(26,386)
Present value of payments	$ 97,932

The table below details the future lease payments due as of December 31, 2009.

Future Minimum Lease Payments	December 31,
2010	$ 64,96
2011	46,950
2012	11,906
2013	501
Total minimum lease payments	$ 124,318

c. Guarantees:

The Company obtained bank guarantees in the amount of $436,000 in connection (i) obligations of two of the Company's subsidiaries to the Israeli customs authorities, and (ii) the obligation of one of the Company's subsidiaries to secure the return of products loaned to the Company from one of its customers. In addition, the Company has outstanding letters of credit totaling $2.9 million for the benefit of its subsidiaries' vendors and customers.

d. Liens:

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

The Company has $8.4 million in credit liens collateralized by the assets of the Company and guaranteed by the Company.

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

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

e. Litigation and other claims:

As of the date of this filing, there were no material pending legal proceedings against the Company, except as follows:

1. NAVAIR Litigation:

In December 2004, AoA filed an action in the United States Court of Federal Claims against the United States Naval Air Systems Command ("NAVAIR"), seeking approximately $2.2 million in damages for NAVAIR's alleged improper termination of a contract for the design, test and manufacture of a lightweight armor replacement system for the United States Marine Corps CH-46E rotor helicopter. NAVAIR, in its answer, counterclaimed for approximately $2.1 million in alleged reprocurement and administrative costs (subsequently revised to approximately $1.5 million). Trial in this matter has concluded and closing briefs and certain supplemental briefs have been filed, but no decision has yet been rendered.

Based on the trial results and subsequent inquiries, the Company, after consultation with its litigation counsel handling this case and with an outside firm with particular expertise in government contract litigation, formed a conclusion that it would be appropriate and prudent to take a allowance against an adverse decision in this case, in the amount of one-half of the amount of NAVAIR's counterclaim. Based on the legal advice received by management, the Company deemed a loss of $750,000 in this case to be a probable outcome as determined under GAAP and recorded the related change as part of Allowances for Settlements.

1. Class Action Litigation:

In May 2007, two purported class action complaints (the "Class Action Complaint") were filed in the United States District Court for the Eastern District of New York against the Company and certain of the Company's officers and directors. These two cases were consolidated in June 2007. The Class Action Complaint seeks class status on behalf of all persons who purchased our securities between November 9, 2004 and November 14, 2005 (the "Period") and alleges violations by us and certain of the Company's officers and directors of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, primarily related to the Company's acquisition of Armour of America in 2005 and certain public statements made by the Company with respect to the Company's business and prospects during the Period. The Class Action Complaint also alleges that the Company did not have adequate systems of internal operational or financial controls, and that the Company's financial statements and reports were not prepared in accordance with GAAP and SEC rules. The Class Action Complaint seeks an unspecified amount of damages.

In January 2010, the Company reached an agreement with lead plaintiffs to settle the Class Action Complaint. Under the terms of the proposed settlement, the lawsuit will be dismissed with prejudice, and the Company and all of the Company's current and former officers and directors named in the complaint will receive a full and complete release of all claims asserted against them in the litigation, as well as any related claims that could have been asserted. The claims will be settled for $2.9 million. The monetary payment for this settlement will be funded entirely from insurance proceeds. The agreement is subject to final court approval, having received preliminary approval in early 2010.

Additionally, on May 6, 2009 a purported shareholders derivative complaint (the "Derivative Complaint") was filed in the United States District Court for the Eastern District of New York against the Company and certain of the Company's officers and directors. The Derivative Complaint is based on the same facts as the class action litigation currently pending against the Company in the same district, and primarily relates to the Company's acquisition of Armour of America in 2005 and certain public statements made by the Company with respect to the Company's business and prospects during the Period. The Derivative Complaint seeks an unspecified amount of damages. The Company has moved for dismissal of the Derivative Complaint.

Although the ultimate outcome of these matters cannot be determined with certainty, the Company believes that the allegations stated in the Class Action Complaint and the Derivative Complaint are without merit and the Company and the Company's officers and directors named in the Complaint intend to defend vigorously against such allegations.

In U.S. dollars

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

a. Subordinated convertible notes due August 15, 2011

In August 2008, the Company issued $5.0 million in 10% subordinated convertible notes due August 15, 2011, the "Notes." The Notes are convertible at the option of the holders at a fixed conversion price of $2.24. The principal amount of the Notes is payable over a period of three years, with the principal amount being amortized in eleven payments payable at the Company's option in cash and/or stock, by requiring the holders to convert a portion of their Notes into shares of the Company's common stock, provided certain conditions are met. The failure to meet such conditions could make the Company unable to pay its Notes, causing it to default. If the price of the Company's common stock is above $2.24, the holders of its Notes will presumably convert their Notes to stock when payments are due, or before, resulting in the issuance of additional shares of the Company's common stock.

The Company primarily made the principal payments in cash, due February, May, August and November 2009 and February 2010 (a portion of the November 2009 and February 2010 principal payment was paid in stock, at the request of one of the Note holders, by the Note holder's conversion of a portion of the quarterly principal payment due for that quarter) and further payments are due in May, August and November 2010, and February, May and August 2011. In the event the Company elects to make payments of principal on its Notes in stock by requiring the holders to convert a portion of their Notes, either because its cash position at the time makes it necessary or it otherwise deems it advisable, the price used to determine the number of shares to be issued on conversion will be calculated using an 8% discount to the average trading price of the Company's common stock during 17 of the 20 consecutive trading days ending two days before the payment date. Accordingly, the lower the market price of the Company's common stock at the time at which it makes payments of principal in stock, the greater the number of shares the Company will be obliged to issue and the greater the dilution to its existing stockholders. This pricing method is also used by the Note holders when all or a portion of the Notes are converted voluntarily.

Convertible notes	**As of December 31,**	
	2009	**2008**
Principal balance	$3,181,820	$5,000,000
Debt discount balance	202,144	471,945

Debt discount is amortized over the term of the note using the effective interest method. $1,818,180 of the Notes are due in 2010 and $1,363,640 are due in 2011.

The Company can require the holder of its Notes to convert a portion of their Notes into shares of the Company's common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. Embedded in the Notes are put options associated with potential defaults, change in control and not meeting certain equity conditions along with a call option available to the Company.

The Notes include certain customary restrictive covenants and rights upon an event of default. The events of default includes suspension of trading, failure to cure a conversion failure, failure to timely make principal and interest payments, defaults on other credit arrangements, bankruptcy, judgments in excess of $1.0 million and generally any uncured breach of the Notes.

Contemporaneously with the signing of a securities purchase agreement for the above Notes, the Company also executed a Registration Rights Agreement. This agreement required the registration of additional shares of the Company and that the registration statement, which was declared effective in 2008, remains effective throughout the term of the Notes. If it were to cease to be effective for any reason, the Company would owe the Note holders 1.5% of the remaining principal amount of the Notes for each month that the registration statement was not effective. The maximum amount due per month as of December 31, 2009 would be $48,000 and decreases as the principal is repaid. Additional requirements of this agreement require the Company to, among other things, abide by all rules and regulations of the SEC and timely file all required reports. As of December 31, 2009, the Company was in compliance with all requirements of this agreement.

In U.S. dollars

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

The original accounting for the Notes included the recording of a debt discount of $412,300 representing the relative fair value of the warrants issued with the convertible debt. The relative fair value of the warrants was $412,300 and recorded as a component of stockholders' equity. The embedded conversion feature did not require bifurcation from the debt and did not result in any beneficial conversion value.

On January 1, 2009, the Company adopted FASB ASC 815-40-15, "Determining Whether an Instrument is Indexed to an Entity's Own Stock." FASB ASC 815-40-15 required the Company to re-evaluate the warrants issued with the convertible notes and to also re-evaluate the embedded conversion option and embedded put options within the Notes to determine if the previous accounting for these items would change. Upon this re-evaluation, the Company was required to record a cumulative adjustment as of January 1, 2009 that included reclassifying the warrant value previously included in stockholders' equity ($412,300) to other liabilities, reflecting the value of the embedded conversion feature as additional debt discount and as other liabilities as of the debt issuance date ($59,001), increasing financial expenses due to the larger debt discount and increasing financial expenses to reflect the change in the value of the warrants and the conversion features from the debt issuance date to December 31, 2008. The aggregate additional 2008 expense of $471,301 was recorded as an adjustment to beginning accumulated deficit as of January 1, 2009.

The embedded put options are now classified as derivative liabilities. The Company again used the Black-Scholes and other valuation techniques to determine the value of the warrants, the embedded conversion feature and the embedded put options associated with the Notes as of January 1, 2009. On December 31, 2009, the Company again revalued these securities. The year to date financial expense associated with this revaluation is approximately $342,000. The table below lists the variables used in the Black-Scholes calculation and the resulting values.

Variables	August 14, 2008	January 1, 2009	December 31, 2009
Stock price	$ 1.68	$ 0.41	$ 1.70
Risk free interest rate	2.72%	1.00%	1.70%
Volatility	77.32%	81.40%	79.85%
Dividend yield	0.00%	0.00%	0.00%
Contractual life	3.0 years	2.6 years	1.6 years

Values	August 14, 2008	January 1, 2009	December 31, 2009
Warrants	$ 417,317	$ 29,171	$ 298,570
Conversion option	143,714	8,013	88,156
Puts	26,060	14,997	7,371
Total value	$ 587,091	$ 52,181	$ 394,097
Change in value – charged to financial expense			$ (341,916)

b. Mortgage Note, Auburn, Alabama:

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

Mortgage - Future Principal Payments	December 31,
2010	$ 29,355
2011	31,792
2012	34,423
2013	37,287
2014	40,382
Thereafter	872,430
	$ 1,045,669

In U.S. dollars

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

The Company has additional long term debt outstanding of approximately $147,000, primarily vehicle loans. This amount is payable through 2012.

NOTE 13:– STOCKHOLDERS' EQUITY

a. Stockholders' rights:

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

b. Warrants:

As part of a securities purchase agreement entered into in August 2008, the Company issued to the purchasers of the Notes, warrants to purchase an aggregate of 558,036 shares of common stock at any time prior to August 15, 2011 at a price of $2.24 per share. The warrants were originally classified as equity based on their relative fair value of $412,300, which was also recorded as a debt discount and none of the warrants have been exercised as of December 31, 2009.

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

1. 2004 Employee Option Plan – 535,714 shares reserved for issuance, of which zero were available for future grants to employees and consultants as of December 31, 2009.

2. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 574,255 were available for future grants to outside directors as of December 31, 2009.

3. 2009 Equity Incentive Plan – 5,000,000 shares reserved for issuance, of which 4,621,666 were available for future grants to employees and consultants as of December 31, 2009.

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

5. A summary of the status of the Company's plans and other share options and restricted shares granted as of December 31, 2009 and 2008, and changes during the years ended on those dates, is presented below:

Stock Options:

	2009		2008	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		$		$
Options outstanding at beginning of year	236,906	$ 6.14	291,390	$ 6.03
Changes during year:				
Granted	–	$ –	–	$ –
Exercised	–	$ –	–	$ –
Forfeited	(17,985)	$ 5.10	(54,484)	$ 5.52
Options outstanding at end of year	218,921	$ 6.23	236,906	$ 6.14
Options vested at end of year (1)	218,921	$ 6.23	203,908	$ 6.69

In U.S. dollars

NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

Options expected to vest	–	$ –	32,998	$ 2.77

(1) Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2009 and 2008 was $849,272 and $1,039,270, respectively.

The calculated intrinsic value of vested and unvested options for 2009 and 2008 was zero.

Restricted Shares:

	2009		2008	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
		$		$
Non-vested at the beginning of the year	713,313	$ 2.41	994,452	$ 2.42
Changes during year:				
Restricted stock granted	412,622	$ 1.46	38,472	$ 2.73
Restricted units granted	77,917	$ 1.67	–	–
Vested	(439,578)	$ 2.18	(244,538)	$ 2.39
Forfeited	(16,735)	$ 2.89	(75,073)	$ 2.22
Non-vested at the end of the year	747,539	$ 1.68	713,313	$ 2.41
Restricted shares vested at end of year	1,232,925	$ 2.40	793,347	$ 2.53

(1) Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2009 and 2008 was $849,272 and $1,039,270, respectively.

6. The options outstanding as of December 31, 2009 have been separated into ranges of exercise price, as follows:

	Total options outstanding			Vested options outstanding	
Range of exercise prices	Amount outstanding at December 31, 2009	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2009	Weighted average exercise price
$		Years	$		$
0.00-4.99	94,000	1.97	$ 2.77	94,000	$ 2.77
5.00-9.99	89,921	2.35	$ 5.91	89,921	$ 5.91
10.00-34.99	35,000	2.30	$ 16.36	35,000	$ 16.36
Total	218,921	2.18	$ 6.23	218,921	$ 6.23

7. Options issued to consultants:

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

	2009		2008	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		$		$
Options outstanding at beginning of year	7,317	$ 68.24	11,870	$ 54.39
Changes during year:				
Granted	–	–	–	–
Exercised	–	–	–	–
Forfeited or cancelled		$	(4,553)	$ 32.12
Options outstanding at end of year	7,317	$ 68.24	7,317	$ 68.24
Options vested at end of year	7,317	$ 68.24	7,317	$ 68.24

8. The remaining total compensation cost related to non-vested stock options and restricted share awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2009 was $277,840, of which zero was for stock options and $277,840 was for restricted shares.

NOTE 13:– STOCKHOLDERS' EQUITY (Cont.)

The weighted average period over which this compensation cost is expected to be recognized is approximately 1.5 years.

9. On January 1, 2009 the Company adopted FASB ASC 260-45-28, Share-Based Payment Arrangements, which classifies unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) as participating securities and requires them to be included in the computation of diluted earnings per share using the two class method. The Company has determined that the unvested restricted stock issued to our employees and directors are "participating securities" and as such, are included, net of estimated forfeitures, in the total shares used to calculate the Company's diluted loss per share but not the basic loss per share as they are anti-dilutive.

d. Dividends:

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

NOTE 14:– INCOME TAXES

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

As of December 31, 2009, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately $25.1 million, which are available to offset future taxable income, if any, expiring in 2010 through 2026. 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 loses before utilization.

The Company adopted the provisions of FASB ASC 740-10 on January 1, 2007. As a result of the implementation of this standard, the Company did not record a liability for unrecognized tax positions. The adoption of this standard did not impact the Company's financial condition, results of operations or cash flows.

At December 31, 2009, the Company had net deferred tax assets of $40.9 million. The deferred tax assets are primarily composed of federal, state and foreign tax net operating loss ("NOL") carryforwards. Due to uncertainties surrounding the Company's ability to generate future taxable income to realize these assets, a full valuation has been established to offset its net deferred tax asset. Additionally, the future utilization of the Company's NOL carryforwards to offset future taxable income is subject to a substantial annual limitation as a result of ownership changes that have occurred. The Company completed an IRS Section 382 analysis in 2007 regarding the limitation of the net operating losses and determined that the maximum amount of U.S. federal NOL available as of January 1, 2007 was $18,851,605, compared to the amount shown on the tax return of $31,161,945. The related Deferred Tax Asset and corresponding valuation allowance were reduced by $4,185,516 for the U.S. federal NOLs and by $3,555,231 for the state NOLs. The Company has also reevaluated the unrecognized tax benefits under this standard as of December 31, 2009 after the completion of the Section 382 review. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in the Company's unrecognized tax benefits will not impact the Company's effective tax rate.

The Company has indefinitely-lived intangible assets consisting of trademarks, workforce, and goodwill. These indefinitely-lived intangible assets are not amortized for financial reporting purposes. However, these assets are tax deductible, and therefore amortized over 15 years for tax purposes. As such, deferred income tax expense and a deferred tax liability arise as a result of the tax-deductibility of these indefinitely-lived intangible assets. The resulting deferred tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a "naked tax credit." This deferred tax liability could remain on the Company's balance sheet indefinitely unless there is an impairment of the related assets (for financial reporting purposes), or the business to which those assets relate were to be disposed of.

NOTE 14:– INCOME TAXES (Cont.)

Due to the fact that the aforementioned deferred tax liability could have an indefinite life, it is not netted against the Company's deferred tax assets when determining the required valuation allowance. Doing so would result in the understatement of the valuation allowance and related deferred income tax expense.

The Company files income tax returns, including returns for its subsidiaries, with federal, state, local and foreign jurisdictions. The Company is no longer subject to IRS examination for periods prior to 2007, although carryforward losses that were generated prior to 2007 may still be adjusted by the IRS if they are used in a future period. Additionally, the Company is no longer subject to examination in Israel for periods prior to 2004.

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

b. Israeli subsidiary (Epsilor):

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

Currently, Epsilor is operating under two programs, as follows:

1. Program one:

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

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

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

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

2. Program two:

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

The expansion program is in the amount of approximately $945,000. This program has received final approval.

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

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

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

3. Additional Approved Enterprise information::

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

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 26% in 2009 and 25% in 2010 and thereafter.

If retained tax-exempt profits attributable to the "approved enterprise" are distributed, they would be taxed at the corporate tax rate applicable to such profits as if Epsilor had not elected the alternative system of benefits, currently 25% for an "approved enterprise."

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

Dividends paid from the profits of an approved enterprise are subject to tax at the rate of 15% in the hands of their recipient. As of December 31, 2009 there are no tax exempt profits earned by Epsilor's "approved enterprises" by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2009. Furthermore, management has indicated that it has no intention of declaring any dividend.

On April 1, 2005, an amendment to the Investment Law came into effect (the "Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export.

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the existing Approved Enterprise of the Israeli subsidiaries (program one) will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Amended Investment Law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2009, the Company did not generate income under the provision of the amended Investment Law.

c. Other tax information about the Israeli subsidiaries:

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

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

2. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 26% in 2009 and 25% in 2010 and thereafter. See also Note 14.e.

3. Tax loss carryforwards:

As of December 31, 2009, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately $111.3 million, which are available, indefinitely (but nonetheless fully reserved), to offset future taxable income.

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

The corporate tax rate in Israel is 26% for 2009 and 25% for 2010 and thereafter, although this is subject to being changed by the Israeli parliament.

e. Deferred income taxes:

Deferred income taxes reflect tax credit carryforwards and 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 are as follows:

Significant components of deferred tax assets

	December 31,	
	2009	**2008**
Operating loss carryforward	$ 34,958,554	$ 34,958,606
Other temporary differences	5,942,973	2,894,915
Net deferred tax asset before valuation allowance	40,901,527	37,853,521
Valuation allowance	(40,860,122)	(37,781,407)
Total deferred tax asset	$ 41,405	$ 72,114
Deferred tax liability	$ 2,990,000	$ 2,430,000

In U.S. dollars

NOTE 14:– INCOME TAXES (Cont.)

Operating loss carryforward – Domestic and Foreign

	December 31, 2009	December 31, 2008
Domestic	$ 8,538,666	$ 8,470,576
Foreign	26,419,889	26,488,030
	$ 34,958,554	$ 34,958,606

The Company has not recorded any deferred taxes on the cumulative undistributed earnings of other non-U.S. subsidiaries because the earnings are intended to be indefinitely re-invested in those operations and the Company is unable, at this time, to estimate the amount. Accrued income taxes on the undistributed earnings of domestic subsidiaries and affiliates are not provided because dividends received from domestic companies are expected to be non-taxable.

The Company provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax assets related to the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance during 2009 was $3.1 million.

f. Profit (loss) before taxes on income and affiliated interests in earnings of a subsidiary are as follows:

	Year ended December 31 2009	Year ended December 31 2008
Domestic	$ (2,300,061)	$ (1,929,564)
Foreign	51,218	(881,524)
	$ (2,248,843)	$ (2,811,088)

g. Taxes on income were comprised of the following:

	Year ended December 31 2009	Year ended December 31 2008
Current state and local taxes	$ 252,426	$ 499,196
Deferred taxes	590,709	570,595
Taxes in respect of prior years	(38,169)	(42,923)
	$ 804,966	$ 1,026,868
Domestic	$ 776,040	$ 926,182
Foreign	28,926	100,686
	$ 804,966	$ 1,026,868

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

	Year ended December 31, 2009	Year ended December 31, 2008
Loss before taxes and noncontrolling interest, as reported in the consolidated statements of operations	$(2,248,843)	$(2,811,088)
Statutory tax rate	34%	34%
Theoretical income tax on the above amount at the U.S. statutory tax rate	$ (764,607)	$ (955,770)
Deferred taxes on losses for which valuation allowance was provided	1,161,957	1,872,798
Non-deductible credits (expenses)	162,650	(352,029)
Foreign non-deductible expenses	72,800	32,400
State taxes, net of federal benefit	216,040	361,182
Foreign income in tax rates other than U.S rate	(11,196)	(35,782)
Taxes in respect of prior years	(38,169)	(42,923)
Others	5,491	146,992
Actual tax expense	$ 804,966	$ 1,026,868

In U.S. dollars

NOTE 15:– SELECTED STATEMENTS OF OPERATIONS DATA

Financial expenses, net:

	Year ended December 31, 2009	Year ended December 31, 2008
Financial expenses:		
Interest, bank charges and fees	$ (715,606)	$ (579,913)
Bonds discount amortization	(662,417)	(51,537)
Foreign currency translation differences	(129,468)	(291,869)
Other	–	(99)
	(1,507,491)	(923,418)
Financial income:		
Interest	243,212	97,851
Other	12,894	11,478
Total	$ (1,251,385)	$ (814,089)

NOTE 16:– SEGMENT INFORMATION

a. General:

The Company operates primarily in three business segments (see Note 1.a. for a brief description of the Company's business).

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

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

	Training and Simulation	Armor	Battery and Power Systems	All Others	Total
2009					
Revenues from outside customers	$ 39,206,173	$ 17,507,298	$17,820,980	$ –	$ 74,534,451
Depreciation , amortization and impairment expenses (1)	(1,327,231)	(181,657)	(1,031,304)	(179,068)	(2,719,260)
Direct expenses (2)	(32,938,826)	(17,148,480)	(16,861,855)	(6,668,454)	(73,617,615)
Segment net income (loss)	$ 4,940,116	$ 177,161	$ (72,179)	$ (6,847,522)	$ (1,802,424)
Financial expenses	(1,342)	(214,042)	(70,819)	(965,182)	(1,251,385)
Net income (loss)	$4,938,774	$ (36,881)	$ (142,998)	$ (7,812,704)	$ (3,053,809)
Segment assets (3)	$ 45,933,659	$ 12,432,348	$23,618,194	$ 2,133,678	$ 84,117,879
2008					
Revenues from outside customers	$ 36,032,703	$ 17,762,439	$15,153,827	$ –	$ 68,948,969
Depreciation , amortization and impairment expenses (1)	(1,573,017)	(	(	(199,662)	(2,981,786)
Direct expenses (2)	(30,141,747)	(	(14,368,970)	(6,022,534)	(68,991,050)
Segment net income (loss)	$ 4,317,939	$ (871,093)	$ (248,517)	$ (6,222,196)	$ (3,023,867)
Financial expenses	(195)	(	(	(142,706)	(814,089)
Net income (loss)	$ 4	$ (1,228,610)	$ (562,188)	$ (6,364,902)	$ (3,837,956)
Segment assets (3)	$ 48,181,444	$ 12,572,672	$24,037,512	$ 5,003,171	$ 89,794,799

1.
2. (1) Includes depreciation of property and equipment and amortization expenses of intangible assets.
(2) Including, *inter alia*, sales and marketing, general and administrative and tax expenses.
(3) Consisting of all assets.

c. Summary information about geographic areas:

The following presents total revenues according to the locations of the Company's end customers for the years ended December 31, 2009 and 2008, and long-lived assets as of December 31, 2009 and 2008:

In U.S. dollars

NOTE 16:– SEGMENT INFORMATION (Cont.)

	2009		2008	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets
	U.S. dollars			
U.S.A.	$ 54,960,149	$ 31,216,469	$49,386,798	$ 31,794,288
Israel	9,947,724	11,737,637	13,443,119	12,382,351
Japan	3,228,035	–	–	–
Singapore	1,804,992	–	–	–
India	1,200,711	–	1,854,052	–
Germany	552,208	–	951,533	–
England	527,405	–	389,518	–
Trinidad	368,562	–	–	–
Canada	278,535	–	–	–
Taiwan	204,098	–	–	–
Egypt	–	–	538,774	–
Other	1,462,032	–	2,385,175	–
	$ 74,534,451	$42,954,106	$68,948,969	$ 44,176,639

d. Revenues from major customers (as a percentage of consolidated revenues):

	Year ended December 31,	
	2009	2008
Training and Simulation:		
Customer A	32%	37%
Battery and Power Systems:		
Customer B	4%	9%
Customer C	5%	3%
Armor:		
Customer D	13%	13%
Customer E	5%	6%

e. Revenues from major products:

	Year ended December 31,	
	2009	2008
Water activated batteries	$ 2,484,217	$ 1,861,959
Batteries and chargers	15,336,763	13,291,868
Car, aircraft and other armoring	17,507,298	17,762,439
Simulators	39,206,173	36,032,703
Total	$ 74,534,451	$ 68,948,969

NOTE 17:– ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income consists of currency translation adjustments of $1,537,000 and $1,526,000 at December 31, 2009 and 2008, respectively, and unrealized gains on marketable securities of zero and $2,000 at December 31, 2009 and 2008, respectively.

NOTE 18:– AFFILIATED COMPANIES

The Company has investments in two affiliated companies, Center for Transportation Safety, Inc. (25% ownership) and Concord Safety Solutions, Pvt. Ltd. (33% ownership), both of which are accounted for under the equity method of accounting. The value of Center for Transportation Safety has been reduced to zero. The Company's interest in the net losses of the affiliated companies totaled zero and $452,166 in 2009 and 2008, respectively.

\- - - - - - - -

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2009 and 2008

Description	Balance at beginning of period	Additions charged to costs and expenses*	Balance at end of period
Year ended December 31, 2009			
Allowance for doubtful accounts	$ 19,000	$ 28,000	$ 47,000
Allowance for slow moving inventory	1,879,000	12,000	1,891,000
Allowance for settlements	–	1,250,000	1,250,000
Valuation allowance for deferred taxes	37,781,000	3,079,000	40,860,000
Totals	$ 39,679,000	$ 4,369,000	$ 44,048,000
Year ended December 31, 2008			
Allowance for doubtful accounts	$ 25,000	$ (6,000)	$ 19,000
Allowance for slow moving inventory	1,724,000	155,000	1,879,000
Valuation allowance for deferred taxes	37,753,000	28,000	37,781,000
Totals	$ 39,502,000	$ 177,000	$ 39,679,000

*The 2009 and 2008 valuation allowance includes an adjustment to the prior year provision calculation due to changes recognized in the preparation of the actual returns.

AROTECH DIRECTORS

Robert S. Ehrlich, Director
Chairman and Chief Executive Officer,
Arotech Corporation

Edward J. Borey, Director
Consultant

Dr. Jay M. Eastman, Director
President and Chief Executive Officer,
Lucid, Inc.

Steven Esses, Director
President and Chief Operating Officer,
Arotech Corporation

Prof. Seymour Jones, Director
Clinical Professor of Accounting,
New York University Stern School of Business

Michael Marrus, Director
Investment Banker

Elliot Sloyer, Director
Managing Member,
WestLane Capital Management LLC

Arthur S. Leibowitz, Director
Lecturer, Department of Accounting, Finance and Economics
Adelphi University School of Business

AROTECH CORPORATE OFFICERS

Robert S. Ehrlich
Chairman and Chief Executive Officer

Steven Esses
President and Chief Operating Officer

Dean Krutty
President, Training and Simulation Division

Jonathan Whartman
President, Armor Division

Ronen Badichi
President, Battery and Power Systems Division

Yaakov Har-Oz
Senior Vice President, General Counsel and Secretary

Thomas J. Paup
Vice President – Finance and CFO

Norman Johnson
Controller

STOCKHOLDER INFORMATION

Annual Meeting

The annual meeting of stockholders will be held on Monday, August 9, 2010, at 10:00 a.m. local time at the offices of Lowenstein Sandler P.C., 1251 Avenue of the Americas, 18th Floor, New York, New York.

Stock Transfer Agent

American Stock Transfer & Trust Company, 59 Maiden Lane, Plaza Level, New York, New York 10038.

Shares Traded

The stock of Arotech Corporation is traded on the Nasdaq Stock Market under the symbol ARTX.

Forms 10-K

Our Annual Report on Form 10-K provides additional information and is on file with the Securities and Exchange Commission. It is available free of charge upon written request to Stockholder Relations, Arotech Corporation, 1229 Oak Valley Drive, Ann Arbor, Michigan 48108.

Website

Our corporate website is at **http://www.arotech.com**. Reference to our website does not constitute incorporation of any of the information thereon into this annual report.

www.arotech.com

Arotech Corporation
1229 Oak Valley Drive
Ann Arbor, MI 48108
Tel 1-800-281-0356
Fax 1-734-761-5368
info@arotech.com