

AROTECH CORP  
Form 10-K  
April 01, 2013

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2012 .

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.

Commission File Number:  
0-23336

AROTECH CORPORATION  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

95-4302784  
(I.R.S. Employer Identification No.)

1229 Oak Valley Drive, Ann Arbor, Michigan  
(Address of principal executive offices)

48108  
(Zip Code)

(800) 281-0356  
(Registrant's telephone number, including area code)

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

| Title of each class            | Name of each exchange on which registered |
|--------------------------------|---|
| Common Stock, \$0.01 par value | The Nasdaq Stock Market LLC               |

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes o No x

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

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

Large accelerated filer: ☐ Accelerated filer: ☐ Non-accelerated filer: ☐ Smaller reporting company: ☒

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

The aggregate market value of the registrant's voting stock held by non-affiliates of the registrant as of June 29, 2012 was approximately \$13,134,959 (based on the last sale price of such stock on such date as reported by The Nasdaq Global Market and assuming, for the purpose of this calculation only, that all of the registrant's directors and executive officers are affiliates).

(Applicable only to corporate registrants) Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 16,174,187 as of 3/31/2013

Documents incorporated by reference: None

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PRELIMINARY NOTE

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

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

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PART I

ITEM 1. BUSINESS

General

We are a defense and security products and services company, engaged in two business areas: 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 two divisions. Our divisions and subsidiaries (both 100% owned by us) are as follows:

- Ø 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
  - Through FAAC, we provide specialized “use of force” training for police, security personnel and the military under the trade name IES Interactive Training (“IES”).
- Ø We manufacture and sell lithium and Zinc-Air batteries for defense and security products, including our Soldier Wearable Integrated Power Equipment System (SWIPES)<sup>TM</sup> power hubs, 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 under our Epsilor nameplate (“Epsilor”), through our subsidiary Epsilor-Electric Fuel, Ltd. (“Epsilor-EFL”), at Epsilor-EFL’s facilities located in Dimona, Israel (in Israel’s Negev desert area);
  - 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, as well as our Soldier Wearable Integrated Power Equipment System (SWIPES)<sup>TM</sup> power hub product, 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 under our Electric Fuel nameplate (“EFL”), at Epsilor-EFL’s facilities located in Beit Shemesh, Israel (between Jerusalem and Tel-Aviv).

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 subsidiary Epsilor-EFL; and Arotech’s wholly-owned United States subsidiaries, EFB and FAAC. Additionally, we operate under the trade names of IES Interactive Training (“IES”), Realtime Technologies (“RTI”) and Electric Fuel Limited (“EFL”). Unless otherwise indicated, all reported figures include only these operations and exclude the discontinued Armor segment.

Between 2002 and December 2011, we were also engaged in utilizing advanced engineering concepts to manufacture military and paramilitary armored vehicles, and employing sophisticated lightweight materials to produce aviation

armor, through our Armor Division. In December 2011, our Board of Directors approved management's plan to sell our Armor Division in order to focus on the more profitable and growth-oriented aspects of our business. We completed the sale of our Armor Division in June 2012.

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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](http://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 Epsilon-EFL are located in Israel (in Beit Shemesh and Dimona, both of which are within Israel's pre-1967 borders). Most of the members of our senior management work extensively out of Epsilon-EFL's facilities in Beit Shemesh; 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, Royal Oak, Michigan and Orlando, Florida. The facilities of EFB 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 larger of our two divisions. During 2012 and 2011, revenues from our Training and Simulation Division were approximately \$59.3 million and \$42.9 million, respectively.

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

- Ø Our Vehicle Simulation group provides high fidelity vehicle simulators for use in operator training and is marketed under our FAAC and Realtime Technologies nameplates;
- Ø 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
- Ø 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 2012, our Vehicle Simulations group accounted for approximately 8.8% 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.

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In January 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, F-22 and Joint Strike Fighter (JSF) fighter aircraft. Additionally, FAAC is a prime contractor in respect of the U.S. Army's Virtual Clearance Training Suite (VCTS) program. In 2012, our Military Operations group (including VCTS) accounted for 78.0% of our Training and Simulation Division's revenues. Our VCTS project accounted for 56.0 % 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 2012, our Use of Force group accounted for 9.8% of our Training and Simulation Division's revenues.

### Warranty

We typically offer a one to two year warranty for most of our products. Additionally, we sell extended warranties to our existing customers. In 2012, warranty revenue accounted for 3.4% 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.

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### 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.

### 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 2012 and 2011, revenues from our Battery and Power Systems Division were approximately \$20.8 million and \$19.3 million, respectively.

### Lithium Batteries and Charging Systems for the Military

#### Introduction

We sell lithium batteries and charging systems, including the SWIPES™ power hubs we produce for the Army's Soldier Warrior program, to the military through our subsidiaries Epsilor-EFL and EFB.

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.

Our Soldier Wearable Integrated Power Equipment System, or SWIPES™, power hub utilizes the MOLLE vest and integrates force protection electronics and communications equipment with an advanced battery. The system utilizes a modular power distribution system that is powered by BA-8180/U, BA-8140/U Zinc-air batteries or the LI-145, BB2590 rechargeable batteries for direct power of equipment, allowing for extended mission times without the burden of power source swaps or charging due to their high energy density, and reducing battery weight soldiers carry by up to 30%. The batteries continuously charge the secondary batteries inside various devices, such as two way radios, GPS units and shot detection systems. The SWIPES™ product allows for individual tailoring by the warfighter and is designed to accept new applications as they become available. The SWIPES™ power hub was recognized by the U.S Army Research, Development and Engineering Command as one of the U.S. Army's ten greatest inventions of 2010.

#### 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.

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### 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. We are now starting direct marketing efforts to emerging markets where we believe the number of local mature competitors is limited.

### Manufacturing

Our battery production lines for military batteries and chargers have been ISO-9001 certified since 1994. We believe that Epsilor-EFL's 23,000 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). Our BA-8180/U Zinc-Air battery was recognized by the U.S. Army Research, Development and Engineering Command as one of the U.S. Army's ten greatest inventions of 2003.

Our Zinc-Air batteries, rechargeable batteries and battery chargers for the military are manufactured through EFB. EFB's facilities have been 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 2012 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 U.S. 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 ( $\text{LiSO}_2$ ) cells. The largest suppliers of  $\text{LiSO}_2$  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 ( $\text{LiMnO}_2$ ) cells. Suppliers of  $\text{LiMnO}_2$  batteries include Ultralife Batteries Inc., Saft and Eagle Picher.

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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 have also become more prevalent in combat use as their energy densities improve, their availability expands and their State-of-Charge Indicator (SOC) 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 Epsilor-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 Epsilor-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, 2012 and 2011, our backlog for the following year was approximately \$87.7 million and \$81.9 million, respectively, divided between our divisions as follows:

| Division                           | 2012          | 2011          |
|------------------------------------|---------------|---------------|
| Training and Simulation Division   | \$ 72,404,000 | \$ 71,732,000 |
| Battery and Power Systems Division | 15,293,000    | 10,196,000    |



|        |    |            |    |            |
|--------|----|------------|----|------------|
| TOTAL: | \$ | 87,697,000 | \$ | 81,928,000 |
|--------|----|------------|----|------------|

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### Major Customers

During 2012 and 2011, including both of our divisions, various branches of the United States military accounted for approximately 54% and 46% of our revenues. See “Item 1A. Risk Factors – Risks Related to Government Contracts,” below.

### Patents and Trade Secrets

We rely on certain proprietary technology and seek to protect our interests through a combination of patents, trademarks, copyrights, know-how, trade secrets and security measures, including confidentiality agreements. Our policy generally is to secure protection for significant innovations to the fullest extent practicable. Further, we seek to expand and improve the technological base and individual features of our products through ongoing research and development programs.

We rely on the laws of unfair competition and trade secrets to protect our proprietary rights. We attempt to protect our trade secrets and other proprietary information through confidentiality and non-disclosure agreements with customers, suppliers, employees and consultants, and through other security measures. However, we may be unable to detect the unauthorized use of, or take appropriate steps to enforce our intellectual property rights. Effective trade secret protection may not be available in every country in which we offer or intend to offer our products and services to the same extent as in the United States. Failure to adequately protect our intellectual property could harm or even destroy our brands and impair our ability to compete effectively. Further, enforcing our intellectual property rights could result in the expenditure of significant financial and managerial resources and may not prove successful. Although we intend to protect our rights vigorously, there can be no assurance that these measures will be successful.

### Research and Development

During the years ended December 31, 2012 and 2011, our gross research and product development expenditures were approximately \$2.0 million and \$1.4 million, respectively.

### Employees

As of December 31, 2012, we had approximately 340 full-time employees worldwide. Our success will depend in large part on our ability to attract and retain skilled and experienced employees.

With respect to those of our employees who are Israeli residents, Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without due cause; additionally, some of our senior employees have special severance arrangements, certain of which are described under “Item 11. Executive Compensation – Employment Contracts,” below. We currently partially fund our ongoing severance obligations by making monthly payments to approved severance funds or insurance policies.

## ITEM 1A. RISK FACTORS

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

### Business-Related Risks

We have had a history of losses and may incur future losses.

We were incorporated in 1990 and began our operations in 1991. We have funded our operations principally from funds raised in the initial public offering of our common stock in February 1994; subsequent public and private offerings of our common stock and equity and debt securities convertible or exercisable into shares of our common stock; research contracts and supply contracts; funds received under research and development grants from the Government of Israel; and sales of products that we and our subsidiaries manufacture. We have incurred significant net losses since our inception. Additionally, as of December 31, 2012, we had an accumulated deficit (including discontinued operations) of approximately \$185.4 million. In an effort to reduce operating expenses and maximize available resources, we have consolidated certain of our subsidiaries, shifted personnel and reassigned responsibilities. We have also taken a variety of other measures to limit spending and will continue to assess our internal processes to seek additional cost-structure improvements. Although we believe that such steps will help to reduce our operating expenses and maximize our available resources, there can be no assurance that we will ever be able to achieve or maintain profitability consistently or that our business will continue to exist.

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

We require substantial funds to operate our business, including marketing our products and developing and marketing new products and to pay our outstanding debt as it comes due. To the extent that we are unable to fully fund our operations, including repaying our outstanding debt, through profitable sales of our products and services, we will need to seek additional funding, including through the issuance of equity or debt securities. In addition, based on our internal forecasts, the assumptions described under “Liquidity and Capital Resources” below, and subject to the other risk factors described herein, we believe that our present cash position and anticipated cash flows from operations and lines of credit along with a lending commitment from a new lender should be sufficient to satisfy our current estimated cash requirements for 2013. However, in the event our internal forecasts and other assumptions regarding our liquidity prove to be incorrect, we may need to seek additional funding. There can be no assurance that we will obtain any such additional financing in a timely manner, on acceptable terms, or at all. If additional funds are raised by issuing equity securities or convertible debt securities, stockholders may incur further dilution. If we incur additional indebtedness, we may be subject to affirmative and negative covenants that may restrict our ability to operate or finance our business. If additional funding is not secured, we will have to modify, reduce, defer or eliminate parts of our present and anticipated future commitments and/or programs.

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

Our bank and other indebtedness (short and long term) totaled approximately \$11.5 million as of December 31, 2012 (not including trade payables, other account payables, seller-financed mortgages, capital leases, and accrued severance pay), of which \$9.8 million was bank working capital lines of credit. In addition, we may incur additional indebtedness in the future. Accordingly, we are subject to the risks associated with significant indebtedness, including:

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

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

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

A failure to comply with the obligations contained in the agreements governing our indebtedness could result in an event of default under such agreements which could result in an acceleration of debt under other instruments evidencing indebtedness that contain cross-acceleration or cross-default provisions. If our indebtedness were to be accelerated, there can be no assurance that our future cash flow or assets would be sufficient to repay in full such indebtedness. In February 2013, our primary bank increased our credit line by 50%, from \$10.0 million to \$15.0 million, and the expiration of the credit line was extended to May 31, 2015. The new credit agreement also contains

certain covenants for 2013, which are measured on a rolling twelve-month basis, limiting the Maximum Increase in Net Advance to Affiliates to less than 90% of EBITDA and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0.

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We may not generate sufficient cash flow to service all of our debt obligations.

Our ability to make payments on our indebtedness and to fund our operations depends on our ability to generate cash in the future. Our future operating performance is subject to market conditions and business factors that are beyond our control. Consequently, we cannot assure you that we will generate sufficient cash flow to pay the principal and interest on our debt. If our cash flows and capital resources are insufficient to allow us to make scheduled payments on our debt, we may have to reduce or delay capital expenditures, sell assets, seek additional capital or restructure or refinance our debt. We cannot assure you that the terms of our debt will allow for these alternative measures or that such measures would satisfy our scheduled debt service obligations. In addition, in the event that we are required to dispose of material assets or restructure or refinance our debt to meet our debt obligations, we cannot assure you as to the terms of any such transaction or how quickly such transaction could be completed. Our ability to refinance our indebtedness or obtain additional financing will depend on, among other things:

- our financial condition at the time;
- restrictions in the agreements governing our other indebtedness; and
- other factors, including the condition of the financial markets and our industry.

Our earnings may decline if we write off additional goodwill and other intangible assets.

As of December 31, 2012, we had recorded goodwill of \$30.6 million and any future impairment of goodwill or other intangible assets may have a significant impact on earnings. Goodwill is not amortized, but is tested for impairment at the reporting unit level. Goodwill is required to be tested for impairment annually and between annual tests if events or circumstances indicate that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. There are numerous risks that may cause the fair value of a reporting unit to fall below its carrying amount, which could lead to the measurement and recognition of goodwill impairment. These risks include, but are not limited to, adverse changes in legal factors or the business climate, an adverse action or assessment by a regulator, a more-likely-than-not expectation that all or a significant portion of a reporting unit may be disposed of, a sustained decline in our market capitalization, significant negative variances between actual and expected financial results, and lowered expectations of future financial results.

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

Some of the components of our products contain elements that are known to pose potential safety risks. In addition to these risks, there can be no assurance that accidents in our facilities will not occur. Any accident, whether occasioned by the use of all or any part of our products or technology or by our manufacturing operations, could adversely affect commercial acceptance of our products and could result in significant production delays or claims for damages resulting from injuries. Any of these occurrences would materially adversely affect our operations and financial condition. In the event that our products fail to perform as specified, users of these products may assert claims for substantial amounts. These claims could have a materially adverse effect on our financial condition and results of operations. There is no assurance that the amount of the general product liability insurance that we maintain will be sufficient to cover potential claims or that the present amount of insurance can be maintained at the present level of cost, or at all.

We are subject to the Dodd-Frank Wall Street Reform and Consumer Protection Act disclosure requirements regarding the use of “conflict minerals”

Beginning in 2014, the Dodd-Frank Wall Street Reform and Consumer Protection Act will impose new disclosure requirements regarding the use of “conflict minerals” mined from the Democratic Republic of Congo and adjoining countries in products, whether or not these products are manufactured by third parties. The definition of “conflict minerals” includes tin, tantalum, tungsten and gold, and their derivatives, some of which we use in the activities of our Battery Division. These new requirements could affect the pricing, sourcing and availability of minerals used in the manufacture of our products. There will be additional costs associated with complying with the disclosure requirements, such as costs related to determining the source of any conflict minerals used in our products. Our supply chain is complex and we may be unable to verify the origins for all metals used in our products. We may also encounter challenges with our customers and stockholders if we are unable to certify that our products are conflict free.

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Our fields of business are highly competitive.

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

Our defense and security products compete with other manufacturers of specialized training systems.

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

Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours. If we are unable to compete successfully in each of our operating areas, our business and results of operations could be materially adversely affected.

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

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

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

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

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





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We are dependent on key personnel and our business would suffer if we fail to retain them.

We are highly dependent on the president of our FAAC subsidiary and the general managers of our Epsilon-EFL subsidiary and the loss of the services of either or both of these persons could adversely affect us. We are especially dependent on the services of our Chairman and Chief Executive Officer, Robert S. Ehrlich, and our President, Steven Esses. The loss of either Mr. Ehrlich or Mr. Esses could have a material adverse effect on us. We are party to employment agreements with Mr. Ehrlich and Mr. Esses, both which agreements expire at the end of 2013. We do not have key-man life insurance on either Mr. Ehrlich or Mr. Esses.

We face risks related to general domestic and global economic conditions.

In general, our operating results can be significantly affected by negative economic conditions, high labor, material and commodity costs and unforeseen changes in demand for our products and services. These risks are heightened as economic conditions globally have deteriorated significantly and may remain at recessionary levels for the foreseeable future. The current recessionary conditions could have a potentially significant negative impact on demand for our products and services, which may have a direct negative impact on our sales and profitability, as well as our ability to generate sufficient internal cash flows or access credit at reasonable rates to meet future operating expenses, service debt and fund capital expenditures.

We face risks related to the current credit crisis.

Disruption in credit markets may impact demand for our products and services, as well as our ability to manage normal relationships with our customers, suppliers and creditors. Tighter credit markets could result in supplier or customer disruptions.

The potential bankruptcy of certain suppliers could leave us exposed to certain risks of collection of outstanding receivables. If any of our suppliers declare bankruptcy, this could have a material adverse effect on our business, financial condition and results of operations.

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

A significant portion of our sales are made to customers located outside the U.S., primarily in Europe and Asia. In 2012 and 2011, 20.4% and 26.7%, respectively, of our revenues, were derived from sales to customers located outside the U.S. We expect that our international customers will continue to account for a substantial portion of our revenues in the near future. Sales to international customers may be subject to political and economic risks, including political instability, currency controls, exchange rate fluctuations, foreign taxes, longer payment cycles and changes in import/export regulations and tariff rates. In addition, various forms of protectionist trade legislation have been and in the future may be proposed in the U.S. and certain other countries. Any resulting changes in current tariff structures or other trade and monetary policies could adversely affect our sales to international customers. See also "Israel-Related Risks," below.

### Risks Related to Government Contracts

A significant portion of our business is dependent on government contracts and reduction or reallocation of defense or law enforcement spending could reduce our revenues.

Many of our Training and Simulation Division's customers to date have been in the public sector of the U.S., including the federal, state and local governments, and in the public sectors of a number of other countries. Additionally, the majority of EFB's sales to date of battery products for the military and defense sectors have been in the public sector in

the United States. A significant decrease in the overall level or allocation of defense or law enforcement spending in the U.S. or other countries could reduce our revenues and have a material adverse effect on our future results of operations and financial condition.

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

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A decline in the U.S. Government defense budget, changes in budgetary priorities or timing of contract awards may adversely affect our future revenues and limit our growth prospects.

Revenues under contracts with the U.S. Department of Defense (“DoD”), either as a prime contractor or subcontractor to other contractors, represent a substantial portion of our total revenues. Our operating results could be adversely affected by spending caps or changes in the budgetary priorities of the U.S. Government or the DoD, as well as delays in program starts or the award of contracts or task orders under contracts.

In August 2011, Congress enacted the Budget Control Act of 2011 (the “Budget Control Act”) which, while raising the existing statutory limit on the amount of permissible federal debt, also committed the U.S. government to significantly reducing the federal deficit over ten years. The Budget Control Act established caps on discretionary spending through 2021, reducing federal spending by approximately \$940 billion relative to the fiscal year 2012 Presidential Budget submission. It also established a Joint Committee of Congress (the “Joint Committee”) that was responsible for identifying an additional \$1.2 to \$1.5 trillion in deficit reductions by November 23, 2011. The Joint Committee was unable to identify the additional deficit reductions by this deadline thereby triggering a second provision of the Budget Control Act called “sequestration,” which calls for very substantial automatic spending cuts split between defense and non-defense programs originally scheduled to start in January 2013 and continue over a nine-year period. While the sequestration that was scheduled to begin in January 2013 has been deferred until March 2013, and members of Congress are discussing various options to prevent or further defer sequestration and the automatic spending cuts scheduled to begin in March 2013, we cannot predict whether any such efforts will succeed.

While the impact of sequestration is yet to be determined, automatic across-the-board cuts would approximately double the \$487 billion top-line reduction already reflected in the defense funding over a ten-year period, with a \$52 billion reduction occurring in the government’s fiscal year 2013. The resulting automatic across-the-board budget cuts in sequestration could have significant consequences to our business and industry. While it is unclear whether sequestration will occur and what the exact impact of it would be, we are continuously reviewing our operations in an attempt to identify those programs that could be at risk so that we can make appropriate contingency plans. These or other factors could result in a significant decline in, or redirection of, current and future budgets and could adversely affect our operating performance, including the possible loss of revenue and reduction in our operating cash flow.

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

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

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

material adverse effect on our business, financial condition or results of operations.

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We may be liable for penalties under a variety of procurement rules and regulations, and changes in government regulations could adversely impact our revenues, operating expenses and profitability.

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

- the U.S. Federal Acquisition Regulations, which regulate the formation, administration and performance of government contracts;
- the U.S. Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with contract negotiations; and
- the U.S. Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under certain cost-based government contracts.

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

We may not be able to receive or retain the necessary licenses or authorizations required for us to export or re-export our products, technical data or services, or to transfer technology from foreign sources (including our own subsidiaries) and to work collaboratively with them. Denials of such licenses and authorizations could have a material adverse effect on our business and results of operations.

U.S. regulations concerning export controls require us to screen potential customers, destinations, and technology to ensure that sensitive equipment, technology and services are not exported in violation of U.S. policy or diverted to improper uses or users.

In order for us to export certain products, technical data or services, we are required to obtain licenses from the U.S. government, often on a transaction-by-transaction basis. These licenses are generally required for the export of the military versions of our products and technical data and for defense services. We cannot be sure of our ability to obtain the U.S. government licenses or other approvals required to export our products, technical data and services for sales to foreign governments, foreign commercial customers or foreign destinations.

In addition, in order for us to obtain certain technical know-how from foreign vendors and to collaborate on improvements on such technology with foreign vendors, including at times our own foreign subsidiaries, we may need to obtain U.S. government approval for such collaboration through manufacturing license or technical assistance agreements approved by U.S. government export control agencies.

The U.S. government has the right, without notice, to revoke or suspend export licenses and authorizations for reasons of foreign policy, issues over which we have no control.

Failure to receive required licenses or authorizations would hinder our ability to export our products, data and services and to use some advanced technology from foreign sources. This could have a material adverse effect on our business, results of operations and financial condition.

Our failure to comply with export control rules could have a material adverse effect on our business.

Our failure to comply with these rules could expose us to significant criminal or civil enforcement action by the U.S. government, and a conviction could result in denial of export privileges, as well as contractual suspension or debarment under U.S. government contracts, either of which could have a material adverse effect on our business, results of operations and financial condition.

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Our operating margins may decline under our fixed-price contracts if we fail to estimate accurately the time and resources necessary to satisfy our obligations.

Some of our contracts are fixed-price contracts under which we bear the risk of any cost overruns. Our profits are adversely affected if our costs under these contracts exceed the assumptions that we used in bidding for the contract. Often, we are required to fix the price for a contract before we finalize the project specifications, which increases the risk that we will misprice these contracts. The complexity of many of our engagements makes accurately estimating our time and resources more difficult. In the event we fail to estimate our time and resources accurately, our expenses will increase and our profitability, if any, under such contracts will decrease.

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

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

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

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

## Market-Related Risks

The price of our common stock is volatile.

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

- announcements by us, our competitors or our customers;
- the introduction of new or enhanced products and services by us or our competitors;
- changes in the perceived ability to commercialize our technology compared to that of our competitors;
- rumors relating to our competitors or us;
- actual or anticipated fluctuations in our operating results;
- the issuance of our securities, including warrants, in connection with financings and acquisitions; and



- general market or economic conditions.

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If our shares were to be delisted, our stock price might decline further and we might be unable to raise additional capital.

One of the continued listing standards for our stock on the Nasdaq Stock Market (both the Nasdaq Global Market, on which our stock is currently listed, and the Nasdaq Capital Market) is the maintenance of a \$1.00 bid price. Our stock price has periodically traded below \$1.00 in the recent past. If our bid price were to decrease and remain below \$1.00 for 30 consecutive business days, Nasdaq could notify us of our failure to meet the continued listing standards, after which we would have 180 calendar days to correct such failure or be delisted from the Nasdaq Global Market. Although we would have the opportunity to appeal any potential delisting, there can be no assurances that this appeal would be resolved favorably. As a result, there can be no assurance that our common stock will remain listed on the Nasdaq Global Market. If our common stock were to be delisted from the Nasdaq Global Market, we might apply to be listed on the Nasdaq Capital Market if we then met the initial listing standards of the Nasdaq Capital Market (other than the \$1.00 minimum bid standard). If we were to move to the Nasdaq Capital Market, current Nasdaq regulations would give us the opportunity to obtain an additional 180-day grace period if we meet certain net income, stockholders' equity or market capitalization criteria; if at the end of that period we had not yet achieved compliance with the minimum bid price rule, we would be subject to delisting from the Nasdaq Capital Market. Although we would have the opportunity to appeal any potential delisting, there can be no assurances that this appeal would be resolved favorably. In addition, we may be unable to satisfy the other continued listing requirements. As a result, there can be no assurance that our common stock will remain listed on the Nasdaq Stock Market.

While our stock would continue to trade on the over-the-counter bulletin board following any delisting from the Nasdaq, any such delisting of our common stock could have an adverse effect on the market price of, and the efficiency of the trading market for, our common stock. Trading volume of over-the-counter bulletin board stocks has been historically lower and more volatile than stocks traded on an exchange or the Nasdaq Stock Market. As a result, holders of our securities could find it more difficult to sell their securities. Also, if in the future we were to determine that we need to seek additional equity capital, it could have an adverse effect on our ability to raise capital in the public equity markets.

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

We do not anticipate paying cash dividends.

We currently intend to retain any future earnings for funding growth and, as a result, do not expect to pay any cash dividends in the foreseeable future. Additionally, our ability to declare dividends should we decide to do so is restricted by the terms of our debt agreements.

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

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

provisions:

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

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

### Israel-Related Risks

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

The offices and facilities of Epsilon-EFL are located in Israel (in Beit Shemesh and Dimona, both of which are within Israel's pre-1967 borders). Most of our senior management is located in Beit Shemesh. Although we expect that most of our sales will continue to be made to customers outside Israel, we are nonetheless directly affected by economic, political and military conditions in that country. Accordingly, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel.

Historically, Arab states have boycotted any direct trade with Israel and to varying degrees have imposed a secondary boycott on any company carrying on trade with or doing business in Israel. Although in October 1994, the states comprising the Gulf Cooperation Council (Saudi Arabia, the United Arab Emirates, Kuwait, Dubai, Bahrain and Oman) announced that they would no longer adhere to the secondary boycott against Israel, and Israel has entered into certain agreements with Egypt, Jordan, the Palestine Liberation Organization and the Palestinian Authority, Israel has not entered into any peace arrangement with Syria or Lebanon. Moreover, since September 2000, there has been a significant deterioration in Israel's relationship with the Palestinian Authority. Efforts to resolve the problem have failed to result in an agreeable solution.

In July and August of 2006, Israel was involved in a full-scale armed conflict with Hezbollah, a Lebanese Islamist Shiite militia group and political party, in southern Lebanon, which involved missile strikes against civilian targets in northern Israel that resulted in economic losses. On August 14, 2006, a ceasefire was declared relating to that armed conflict, although it is uncertain whether or not the ceasefire will continue to hold.

Israel withdrew unilaterally from the Gaza Strip and certain areas in northern Samaria in 2005. Thereafter Hamas, an Islamist terrorist group responsible for many attacks, including missile strikes against Israeli civilian targets, won the majority of the seats in the Parliament of the Palestinian Authority in January 2006 and took control of the entire Gaza Strip, by force, in June 2007. Since then, Hamas and other Palestinian movements have launched thousands of missiles from the Gaza strip into civilian targets in southern Israel. In late 2008, a sharp increase in rocket fire from Gaza on Israel's western Negev region, extending as far as 25 miles into Israeli territory and disrupting most day-to-day civilian activity in the proximity of the border with the Gaza Strip, prompted the Israeli government to launch military operations against Hamas that lasted approximately three weeks. Israel declared a unilateral ceasefire in January 2009, which substantially diminished the frequency of, but did not eliminate, Hamas rocket attacks against Israeli cities. In November 2012, following an increase in rocket attacks and hostile activity originating from the Gaza Strip, the Israeli government launched an air attack on Hamas. Rockets were fired into Israel extending as far as Tel Aviv and Jerusalem. After seven days, a ceasefire was agreed to by Israel and Hamas. Since then, rocket attacks have been significantly reduced, but not totally stopped. There can be no assurance that this period of relative calm will continue, especially in light of continuing rhetoric between Iran and Israel.

Our Israeli production facilities in the cities of Beit Shemesh and Dimona, are located approximately 27 miles and 38 miles, respectively, from the nearest point of the border with the Gaza Strip. There can be no assurance that Hamas will not begin to use on a more frequent basis longer-range missiles capable of reaching our facilities, which could result in a significant disruption of the Israel-based portion of our business. Additionally, recent political events, including political uprisings, social unrest and regime change, in various countries in the Middle East and North Africa have weakened the stability of those countries, which could result in extremists coming to power, including in countries with which Israel has signed peace treaties that may not be respected by extremists. In addition, Iran has threatened to attack Israel and is widely believed to be developing nuclear weapons. Iran is also believed to have a strong influence among extremist groups in the region, such as Hamas in Gaza and Hezbollah in Lebanon. This situation may potentially escalate in the future to violent events which may affect Israel and us. Any major hostilities involving Israel, including as a result of the military conflicts between the Fatah and Hamas in Gaza Strip, Judea and Samaria, or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, operating results and financial condition.

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In addition to the foregoing, since the end of 2010, numerous acts of protest and civil unrest have taken place in several countries in the Middle East and North Africa, many of which involved significant violence. The civil unrest in Egypt, which borders Israel, resulted in significant changes to the country's government. In Syria, also bordering Israel, large and violent protests against the government are taking place. The ultimate effect of these developments on the political and security situation in the Middle East and on Israel's position within the region is not clear at this time.

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

We are organized under the laws of the State of Delaware and will be subject to service of process in the United States. However, approximately 26.9% of our assets are located outside the United States. In addition, two of our directors and some of our executive officers are residents of Israel and a portion of the assets of such directors and executive officers are located outside the United States.

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

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

Although a substantial majority of our revenues and a substantial portion of our expenses are denominated in U.S. dollars, a portion of our costs, including personnel and facilities-related expenses, is incurred in New Israeli Shekels (NIS). Inflation in Israel will have the effect of increasing the dollar cost of our operations in Israel, unless it is offset on a timely basis by a devaluation of the NIS relative to the dollar. In 2012, the inflation-adjusted NIS appreciated against the dollar.

### ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

### ITEM 2. PROPERTIES

Our primary executive offices are located in FAAC's offices, consisting of approximately 17,300 square feet of office and warehouse space in Ann Arbor, Michigan, pursuant to a lease expiring in July 2018. FAAC has also leased 17,200 square feet of office and warehouse space adjacent to our main offices pursuant to a lease beginning in June 2006 and expiring in July 2017. Additionally, pursuant to a lease expiring in October 2014, FAAC is leasing approximately 10,000 square feet of office and lab space in Orlando, Florida. FAAC also leases approximately 6,900 square feet in Royal Oak, Michigan pursuant to a lease terminating in April 2014.

In August 2011, FAAC purchased 40,000 square feet of office and warehouse space in Ann Arbor, Michigan, approximately three miles from its current location, where it began to consolidate certain of its operations beginning in 2011. Subsequently, in December 2012, FAAC leased 7,000 square feet of surplus space of the purchased building to a non-profit organization as office space for a term of 10 years with an option to terminate the lease at any time after May 2018 with a one year prior notice given at any time after May 2017.

EFB operates out of our leased Auburn, Alabama facilities, constituting approximately 30,000 square feet, which is leased from the City of Auburn through January, 2014.



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Our management and administrative facilities and research, development and production facilities for the manufacture and assembly of our Survivor Locator Lights, constituting approximately 21,000 square feet, are located in Beit Shemesh, Israel, located between Jerusalem and Tel-Aviv (within Israel's pre-1967 borders). The lease for these facilities in Israel expires on December 31, 2017; we have the ability to terminate the lease upon three months' written notice at the end of November 2013. Most of the members of our senior management, including our Chief Executive Officer and our President, work extensively out of our Beit Shemesh facility. Our Chief Financial Officer works out of our Ann Arbor, Michigan facility.

Our Epsilon-EFL subsidiary rents approximately 23,000 square feet of factory, office and warehouse space in Dimona, Israel, in Israel's Negev desert (within Israel's pre-1967 borders), on a month-to-month basis.

In March 2007, we purchased 16,700 square feet of space for the now discontinued Armor Division in Auburn, Alabama for approximately \$1.1 million pursuant to a seller-financed secured purchase money mortgage. Half of 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 building is currently leased to a third party and has been listed for sale with a local real estate agent. Additionally, the carrying value of this property was written down to zero as part of the 2011 Armor Division impairment.

We believe that our existing and currently planned facilities are adequate to meet our current and foreseeable future needs.

ITEM 3. LEGAL PROCEEDINGS

As of the date of this filing, there were no material pending legal proceedings against us, and there were no material legal proceedings active against us during 2012.

ITEM 4. MINE SAFETY DISCLOSURES

None.



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## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RE-LATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

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 sales prices of our common stock on the Nasdaq Global Market System:

| Year Ended December 31, 2012 | High    | Low     |
|------------------------------|---------|---------|
| Fourth Quarter               | \$ 1.18 | \$ 0.90 |
| Third Quarter                | \$ 1.00 | \$ 0.71 |
| Second Quarter               | \$ 1.30 | \$ 0.85 |
| First Quarter                | \$ 1.39 | \$ 1.11 |
| Year Ended December 31, 2011 | High    | Low     |
| Fourth Quarter               | \$ 1.64 | \$ 1.11 |
| Third Quarter                | \$ 2.24 | \$ 1.31 |
| Second Quarter               | \$ 2.47 | \$ 1.18 |
| First Quarter                | \$ 1.74 | \$ 1.29 |

As of February 28, 2013 we had approximately 169 holders of record of our common stock.

## Share Repurchase Program

In February of 2009, we authorized the repurchase in the open market or in privately negotiated transactions of up to \$1.0 million of our common stock. Pursuant to this plan, through December 31, 2012 we have repurchased 638,611 shares of our common stock for \$869,931 (\$857,018 net of commissions), all of which was purchased after April 1, 2009. We did not repurchase any shares during 2012.

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.

## Annual Stockholders Meeting

We held our 2012 Annual Meeting of Stockholders on August 13, 2012. Our 2013 Annual Meeting of Stockholders will be held on Monday, June 24, 2013 commencing at 9:00 a.m., eastern daylight time, by webcast.

In light of the foregoing and in accordance with Rules 14a-5(f) and 14a-8(e)(2) under the Securities Exchange Act of 1934, as amended, we will consider stockholder proposals submitted in connection with our 2013 Annual Meeting to have been submitted in a timely fashion if such proposals are received by us at our principal offices no later than April 15, 2013. If a proposal is received after April 15, 2013, the proxies designated by the Board of Directors of the Company will have discretionary authority to vote on the proposal under circumstances consistent with the proxy

rules of the Securities and Exchange Commission.

We expect to mail our Notice of Annual Meeting and Notice of Internet Availability of Proxy Materials, containing links to our Annual Report to Stockholders for the year ended December 31, 2012 and our Proxy Statement for the 2013 Annual Meeting, on or about May 14, 2013.

ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

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ITEM 7. 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 "Risk Factors," above, and in our other 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 two business areas: interactive simulation for military, law enforcement and commercial markets; and batteries and charging systems for the military. We operate in two business units:

- Ø 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 (our Training and Simulation Division); and
- Ø We manufacture and sell lithium and Zinc-Air batteries for defense and security products, including our Soldier Wearable Integrated Power Equipment System (SWIPES)<sup>TM</sup> power hubs, and other military applications (our Battery and Power Systems Division).

Between 2002 and December 2011, we were also engaged in utilizing advanced engineering concepts to manufacture military and paramilitary armored vehicles, and employing sophisticated lightweight materials to produce aviation armor, through our Armor Division. In December 2011, our Board of Directors approved management's plan to sell our Armor Division in order to focus on the more profitable and growth-oriented aspects of our business. We completed the sale of our Armor Division in June 2012.

The discontinuation of the Armor Division for accounting purposes resulted in a one-time, pre-tax charge during the fourth quarter of 2011 of approximately \$3.9 million, reflecting an impairment of goodwill and intangibles (\$1.8 million), an impairment of other long-lived assets (\$1.5 million), a write-off of a joint venture investment (\$269,000), and costs associated with change of control provisions and other non-statutory severance expenses (\$302,000). Almost all these charges are non-cash impacting items. In 2012, an additional pre-tax adjustment of approximately \$829,000 was recorded to reflect a loss upon the sale.

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 deferred warranty revenue, 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.

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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.

### 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. 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 of options 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.

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### 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.

We have provided a valuation allowance on 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 our deferred tax assets in the U.S. and Israel 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 re-invested indefinitely.

We have indefinitely-lived intangible assets consisting of trademarks 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 for continuing operations 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.

We have 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 our future financial statements.

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.





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### 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 2012, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

### Goodwill

As of December 31, 2012, we had recorded goodwill of \$30.6 million (subsequent to the 2011 goodwill impairment in the amount of \$1.8 million in connection with our decision to reflect the operations of the Armor Division as discontinued, referred to below). We allocate goodwill acquired in a business combination to the appropriate reporting unit as of the acquisition date. Currently our reporting units are also our reportable segments and the associated goodwill was determined when the specific businesses in the reportable segments were purchased. 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.

In September 2011, the FASB issued ASU No. 2011-08, "Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment." ASU 2011-08 amends the guidance in Accounting Standards Codification ASC 350-10. Under the revised guidance, when testing goodwill for impairment we have the option of performing a qualitative assessment before calculating the fair value of a reporting unit. If we determine, on the basis of qualitative factors, that it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, the two-step impairment test would not be required. If we cannot determine on the basis of qualitative factors that goodwill is not impaired, goodwill is then tested for impairment by 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, 2012 along with our forecasted plan developed in the fourth quarter. We use a June 30 date because this allows us to use internal resources that are available before we start our annual audit process (we wait until our June 30 financials were reviewed by our external auditors before we start the actual goodwill impairment analysis). In both 2012 and 2011, we determined, using qualitative factors, that the Training and Simulation goodwill was not impaired. In both 2012 and 2011, we completed the first step of the quantitative analysis of the goodwill in the Battery and Power

Systems reporting unit, in which we computed a fair value of that reporting unit. Because the fair value was greater than the carrying value of the unit at the measurement date, the second step of the quantitative impairment assessment was not required and no goodwill was impaired. Although the valuation for Battery and Power Systems Division exceeded the reporting unit's carrying value by 14%, we will continue to monitor the actual results of the reporting unit versus the forecast used for the impairment review and re-evaluate the goodwill as required.

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Subsequent to our 2011 annual goodwill impairment review, in December 2011, in connection with our decision to sell our Armor Division and to reflect the operations of the Armor Division as discontinued, we identified an impairment of goodwill and other intangible assets identified with the Armor Division and, as a result, we recorded a goodwill impairment charge in the amount of \$1.8 million during the fourth quarter of 2011.

Although the cumulative carrying value of our reporting units included in continuing operations 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;
- 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; and
- Control premiums reflected in the reporting unit fair values but not in our stock price.

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 one 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.



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### Warranty Reserves

Upon shipment of products to our customers, we defer revenue for the estimated cost to repair or replace products along with the appropriate margin for goods 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 deferred revenue is estimated based on actual historical experience. For new products, the warranty deferred revenue 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 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 Epsilor is in New Israeli Shekels ("NIS") and a substantial portion of Epsilor's costs is incurred in NIS. Management believes that the NIS is the functional currency of Epsilor. Accordingly, the financial statements of 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, 2012 and 2011. 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 2012 and 2011 arose as a result of non-cash and impairment charges. These charges were primarily related to our prior acquisitions, financings and stock-based awards to employees. To the extent that we continue certain of these activities during 2013, 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 2012. 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 an 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.

We incurred non-cash charges for amortization of intangible assets in 2012 and 2011 in the amount of \$1.2 million and \$1.9 million, respectively. In addition, we incurred non-cash charges in discontinued operations for impairment of goodwill and other intangible assets in the amount of \$1.8 million during 2011 in respect of our Armor Division. See “Critical Accounting Policies – Goodwill,” above.

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### Financings and Issuances of Restricted Shares, Restricted Stock Units, Options and Warrants

The non-cash charges that relate to our financings occurred in connection with our issuance of convertible debt securities with detachable warrants. When we issued convertible securities, we recorded a discount (representing the value of the detachable warrants and the derivative features of the debt) that was amortized ratably over the life of the debenture. When a debenture is converted, however, the entire remaining unamortized discount was immediately recognized as expense in the quarter in which the debenture was converted. During 2012 and 2011, we recorded credits of approximately zero and \$161,000, respectively, attributable to debt discount amortization.

During 2012 and 2011, we issued restricted shares and restricted stock units to certain of our employees and to our directors. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock. 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 or restricted stock units (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.

We incurred non-cash charges related to stock-based compensation in 2012 and 2011 in the amount of \$448,000 and \$408,000, 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 were convertible at any time prior to August 15, 2011 at a conversion price of \$2.24 per share.

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. Due to certain exercise price reset provisions, the warrants were accounted for as liabilities at fair value with changes in fair value reflected as financial income or expense amounting to \$161,000 of income in 2011 through the date such warrants expired unexercised.

### Overview of Operating Performance and Backlog

Overall, our pre-tax loss from continuing operations for 2012 was \$1.4 million on revenues of \$80.1 million, compared to a pre-tax loss of \$3.4 million on revenues of \$62.1 million during 2011. As of December 31, 2012, our overall backlog for continuing operations totaled \$87.7 million.

In our Training and Simulation Division, revenues increased from approximately \$42.9 million in 2011 to \$59.3 million in 2012. As of December 31, 2012, our backlog for our Training and Simulation Division totaled \$72.4 million.

In our Battery and Power Systems Division, revenues increased from approximately \$19.3 million in 2011 to approximately \$20.8 million in 2012. As of December 31, 2012, our backlog for our Battery and Power Systems Division totaled \$15.3 million.

### Common Stock Repurchase Program

In February 2009, we authorized the repurchase in the open market or in privately negotiated transactions of up to \$1.0 million of our common stock. Pursuant to this plan, through December 31, 2012 we have repurchased 638,611

shares of our common stock for \$869,931 (\$857,018 net of commissions), all of which was purchased after April 1, 2009. At December 31, 2012, we had remaining authorization for the repurchase of up to \$142,982 in shares of our common stock. The repurchase program, which expires on August 13, 2013, is subject to the discretion of our management.

#### Results of Operations

Results exclude the operations of the Armor Division, which we reflect as discontinued.



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## Summary

Following is a table summarizing our results of continuing operations for the years ended December 31, 2012 and 2011, after which we present a narrative discussion and analysis:

|                                      | Year Ended December 31, |                |
|--------------------------------------|-------------------------|----------------|
|                                      | 2012                    | 2011           |
| Revenues:                            |                         |                |
| Training and Simulation Division     | \$59,270,768            | \$42,881,573   |
| Battery and Power Systems Division   | 20,779,666              | 19,254,005     |
|                                      | \$80,050,434            | \$62,135,578   |
| Cost of revenues:                    |                         |                |
| Training and Simulation Division     | \$44,822,270            | \$29,715,897   |
| Battery and Power Systems Division   | 17,318,768              | 16,235,033     |
|                                      | \$62,141,038            | \$45,950,930   |
| Research and development expenses:   |                         |                |
| Training and Simulation Division     | \$698,349               | \$819,879      |
| Battery and Power Systems Division   | 1,345,369               | 581,989        |
|                                      | \$2,043,718             | \$1,401,868    |
| Selling and marketing expenses:      |                         |                |
| Training and Simulation Division     | \$4,513,244             | \$4,399,952    |
| Battery and Power Systems Division   | 974,666                 | 854,939        |
|                                      | \$5,487,910             | \$5,254,891    |
| General and administrative expenses: |                         |                |
| Training and Simulation Division     | \$3,456,873             | \$3,844,279    |
| Battery and Power Systems Division   | 946,727                 | 1,211,114      |
| Corporate                            | 5,649,165               | 5,622,462      |
|                                      | \$10,052,765            | \$10,677,855   |
| Amortization of intangible assets:   |                         |                |
| Training and Simulation Division     | \$676,299               | \$1,395,857    |
| Battery and Power Systems Division   | 509,240                 | 509,240        |
|                                      | \$1,185,539             | \$1,905,097    |
| Operating income (loss):             |                         |                |
| Training and Simulation Division     | \$5,103,733             | \$2,705,709    |
| Battery and Power Systems Division   | (315,104 )              | (138,310 )     |
| Corporate                            | (5,649,165 )            | (5,622,462 )   |
|                                      | \$(860,536 )            | \$(3,055,063 ) |
| Other income:                        |                         |                |
| Training and Simulation Division     | \$(5,926 )              | \$37,567       |
| Battery and Power Systems Division   | (2,327 )                | —              |
| Corporate                            | (31 )                   | 6,285          |
|                                      | \$(8,284 )              | \$43,852       |
| Allowance for settlements:           |                         |                |
| Corporate                            | \$—                     | \$12,333       |
|                                      | \$—                     | \$12,333       |
| Financial expense (income):          |                         |                |
| Training and Simulation Division     | \$43,221                | \$47,112       |
| Battery and Power Systems Division   | 7,639                   | 209,764        |
| Corporate                            | 497,126                 | 74,130         |

|                                    |                |                |
|------------------------------------|----------------|----------------|
|                                    | \$547,986      | \$331,006      |
| Income tax expense (benefit):      |                |                |
| Training and Simulation Division   | \$(7,688 )     | \$(69,734 )    |
| Battery and Power Systems Division | –              | 646,824        |
| Corporate                          | 635,844        | 1,031,521      |
|                                    | \$628,156      | \$1,608,611    |
| Net loss – continuing operations:  |                |                |
| Training and Simulation Division   | \$5,074,126    | \$2,765,898    |
| Battery and Power Systems Division | (320,416 )     | (994,898 )     |
| Corporate                          | (6,782,104 )   | (6,734,161 )   |
|                                    | \$(2,028,394 ) | \$(4,963,161 ) |

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Fiscal Year 2012 compared to Fiscal Year 2011

Revenues. During 2012, we (through our subsidiaries) recognized revenues as follows:

- Ø Training and Simulation Division - 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.
- Ø Battery and Power Systems Division - EFB and Epsilor-EFL recognized revenues from the sale of batteries, chargers, adapters and power hub products to the military and commercial customers, and under certain development contracts with the U.S. Army.
- Ø Battery and Power Systems Division - Epsilor-EFL also recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for continuing operations for 2012 totaled \$80.1 million, compared to \$62.1 million in 2011, an increase of \$18.0 million, or 28.8%. This increase was primarily attributable to the following factors:

- Ø Increased revenues from our Training and Simulation Division (\$16.4 million more in 2012 versus 2011), due primarily to revenue in 2012 related to a major new contract (VCTS).
- Ø Increased revenues from our Battery and Power Systems Division (\$1.5 million more in 2012 versus 2011), due to an increase of \$3.2 million in U.S. sales of SWIPES™, partially offset by a \$1.3 million decrease in Israeli sales.

The table below details the percentage of total recognized revenue by type of arrangement for the years ended December 31, 2012 and 2011:

| Type of Revenue                              | Year Ended December 31, |   |       |   |
|--|-------------------------|---|-------|---|
|  | 2012                    |   | 2011  |   |
| Sale of products                             | 96.0                    | % | 93.8  | % |
| Maintenance and support agreements           | 2.8                     | % | 4.3   | % |
| Long term research and development contracts | 1.2                     | % | 1.9   | % |
| Total  | 100.0                   | % | 100.0 | % |

Cost of revenues. Cost of revenues totaled \$62.1 million during 2012, compared to \$46.0 million in 2011, an increase of \$16.1 million, or 35.2%, due primarily to increased revenues in our Training and Simulation Division and the higher costs associated with the new VCTS contract, as well as increased sales in the U.S. of the SWIPES™ system. Cost of revenues as a percentage of revenue remained essentially flat in our Battery and Power Systems Division but increased in our Training and Simulation Division due primarily to the product mix and the VCTS contract.

Research and development expenses. Research and development expenses for 2012 were \$2.0 million, compared to \$1.4 million during 2011, an increase of \$642,000, or 45.8%, due primarily to increased spending in the Battery and Power Systems Division for continuing research on the SWIPES™ system, offset by a small reduction of expenses in the Training and Simulation Division.

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**Selling and marketing expenses.** Selling and marketing expenses for 2012 were \$5.5 million, compared to \$5.3 million in 2011, an increase of \$233,000, or 4.4%, due primarily to an increase in the sales force and increases in the demonstration of new products to the military in the Battery and Power Systems Division.

**General and administrative expenses.** General and administrative expenses for 2012 were \$10.1 million, compared to \$10.7 million in 2011, a decrease of \$625,000, or 5.9%. This decrease was primarily attributable to reductions in corporate and division compensation of \$568,000 and a \$128,000 reduction in legal expense compared to 2011.

**Amortization of intangible assets.** Amortization of intangible assets totaled \$1.2 million in 2012, compared to \$1.9 million in 2011, a decrease of \$720,000, or 37.8%, due primarily to decreased charges for fully amortized capitalized software in our Training and Simulation Division.

**Financial expenses, net.** Financial expense totaled \$548,000 in 2012, compared to financial expense of 331,000 in 2011, an increase of \$217,000, or 65.6%, due primarily to an increase in corporate interest and bank charges of \$239,000 along with a \$161,000 decrease in credits recorded in 2011 for warrants. The expense increase was offset by a foreign currency adjustment of \$(345,000).

**Income taxes.** With respect to some of our subsidiaries that generated net income during 2012, we were able to offset federal taxes against our accumulated loss carry forward. We recorded \$628,000 in tax expense in 2012, compared to \$1.6 million in tax expense in 2011, a decrease of \$980,000, or 61.0%, mainly concerning state and local taxes and taxes in Israel along with “naked” credits (“naked” credits occur when deferred tax liabilities that are created by indefinite-lived assets such as goodwill cannot be used as a source of taxable income to support the realization of deferred tax assets). This amount includes the required adjustment of taxes due to the deduction of goodwill “naked” credits for U.S. federal taxes, which totaled \$599,000 and \$1.0 million respectively, in non-cash expenses in 2012 and 2011.

**Net loss.** Due to the factors cited above, net loss from continuing operations was reduced to \$2.0 million in 2012 from \$5.0 million in 2011, a difference of \$3.0 million.

**Discontinued Operations.** As cited above, we have discontinued our Armor Division (see Note 1.d. of the Notes to the Consolidated Financial Statements), which generated a net loss of \$988,000 2012. During 2012, we had incurred additional expenses related to the sale of the Armor Division. Almost all of these charges are non-cash impacting items.

## **Liquidity and Capital Resources**

As of December 31, 2012, we had \$1.6 million in cash and \$186,000 in restricted collateral deposits, as compared to December 31, 2011, when we had \$2.3 million in cash and \$1.7 million in restricted collateral deposits. We also had \$380,000 in available, unused bank lines of credit with our main bank as of December 31, 2012, 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.

Effective April 30, 2012, we and FAAC entered into an agreement with a different primary bank that has provided us with a replacement \$10.0 million credit facility under our FAAC subsidiary, which is secured by Arotech assets and the assets of our other domestic subsidiaries and guaranteed by Arotech and our other domestic subsidiaries, at a rate of LIBOR plus 375 basis points. This credit facility was scheduled to expire May 2013. The new 2012 credit agreement contains certain covenants, including minimum Earnings Before Interest, Taxes, Depreciation and Amortization (“EBITDA”), quarterly Maximum Increase in Net Advance to Affiliates of less than 90% of EBITDA and an annual Fixed Charge Coverage Ratio of not less than 1.1 to 1.0. At the end of 2012 and as of the filing date of this

report, we met all required current covenants. In February 2013, to support our growth, our primary bank increased our credit line by 50%, from \$10 million to \$15 million, and the expiration of the credit line was extended to May 31, 2015. The new credit agreement carries an interest rate of 30 day LIBOR plus 375 basis points and an unused line of credit fee of 0.35%. The new credit agreement also contains certain covenants, which are measured on a rolling twelve-month basis, limiting the Maximum Increase in Net Advance to Affiliates to less than 90% of EBITDA in 2013 and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0.

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We used available funds in 2012 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We purchased approximately \$950,000 of property and equipment during 2012. Our net property and equipment amounted to \$4.5 million as of December 31, 2012.

Net cash used in operating activities for 2012 and 2011 was \$4.4 million and \$5.8 million, respectively, a net change in usage of \$1.4 million. This difference was due primarily to the increased working capital funding requirements for our major projects at both the Simulation and Training Division (VCTS) and Battery and Power Systems Division (SWIPES<sup>TM</sup>). The timing of cash inflows and outflows has impacted us due to the substantial purchases of products to fulfill these contracts. Additionally, the increases in working capital were offset by a decrease in the net loss from continuing operations of \$2.9 million. Net cash used in operating activities has been impacted by a significant increase in unbilled receivables.

Net cash provided by (used in) investing activities for 2012 and 2011 was \$371,000 and \$(2.7) million, a net change of \$3.1 million. This difference was due primarily to the release of \$1.6 million in restricted funds due to the completion of a significant contract by the Training and Simulation Division along with a reduction of \$1.7 million in property and equipment purchases. This was offset by a redemption of available for sale securities of \$399,000 recorded in 2011.

Net cash provided by financing activities for 2012 and 2011 was \$3.5 million and \$4.6 million, respectively, a change of \$1.1 million. This difference was due primarily to changes in short term borrowing under our primary line of credit to support the timing differences associated with our major projects at the Training and Simulation Division and the Battery and Power Systems Division.

As of December 31, 2012, we had approximately \$9.8 million in short-term bank debt and \$1.9 million in long-term debt outstanding for continuing operations, including current maturities, as compared to December 31, 2011, when we had approximately \$6.6 million in short-term bank debt and \$1.0 million in long-term debt outstanding for continuing operations, including current maturities.

Subject to all of the reservations regarding “forward-looking statements” set forth above, we believe that our present cash position, anticipated cash flows from operations and availability under our lines of credit should be sufficient to satisfy our current estimated cash requirements through the remainder of 2013. 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 infusions. Additionally, we would need to raise additional capital or sell assets 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, 2012 and 2011. With respect to some of our U.S. subsidiaries that operated at a net profit during 2012, we were able to offset federal taxes against our net operating loss carryforward. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. We also set up a tax liability for the impact of the deductions taken for goodwill.

As of December 31, 2012, we had a U.S. net operating loss carryforward of approximately \$43.3 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2020 through 2032, and foreign net operating and capital loss carryforwards of approximately \$85.4 million, which are available indefinitely to offset future taxable income under certain circumstances.



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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2012, 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, 2012, 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.

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.

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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, 2012. 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, 2012.

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 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.

ITEM 9B. OTHER INFORMATION

None.

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## PART III

## ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

## Executive Officers, Directors and Significant Employees

## Executive Officers and Directors

Our executive officers and directors and their ages as of February 28, 2013 were as follows:

| Name                      | Age | Position   |
|---------------------------|-----|--|
| Robert S. Ehrlich         | 75  | Chairman of the Board and Chief Executive Officer    |
| Steven Esses              | 49  | President and Director                               |
| Dr. Jay M. Eastman        | 64  | Director   |
| Edward J. Borey           | 62  | Director   |
| S e y m o u r Jones       | 81  | Director   |
| E l l i o t Sloyer        | 48  | Director   |
| M i c h a e l E . Marrus  | 49  | Director   |
| A r t h u r S . Leibowitz | 59  | Director   |
| T h o m a s J . Paup      | 64  | Vice President – Finance and Chief Financial Officer |

Our by-laws provide for a board of directors of one or more directors. There are currently seven directors. Under the terms of our certificate of incorporation, the board of directors is composed of three classes of similar size, each elected in a different year, so that only one-third of the board of directors is elected in any single year. Dr. Eastman and Messrs. Esses and Marrus are designated Class I directors and have been elected for a term expiring in 2015 and until their successors are elected and qualified; Prof. Jones and Messrs. Ehrlich and Leibowitz are designated Class II directors elected for a term expiring in 2014 and until their successors are elected and qualified; and Messrs. Borey and Sloyer are designated Class III directors elected for a term that expires in 2013 and until their successors are elected and qualified. A majority of the Board is “independent” under relevant SEC and Nasdaq regulations.

Robert S. Ehrlich has been our Chairman of the Board since January 1993 and our Chief Executive Officer since October 2002. From May 1991 until January 1993, Mr. Ehrlich was our Vice Chairman of the Board, from May 1991 until October 2002 he was our Chief Financial Officer, and from October 2002 until December 2005, Mr. Ehrlich also held the title of President. Mr. Ehrlich was a director of Eldat, Ltd., an Israeli manufacturer of electronic shelf labels, from June 1999 to August 2003. From 1987 to June 2003, Mr. Ehrlich served as a director of PSC Inc. (“PSCX”), a manufacturer and marketer of laser diode bar code scanners, and, between April 1997 and June 2003, Mr. Ehrlich was the chairman of the board of PSCX. Mr. Ehrlich received a B.S. and J.D. from Columbia University in New York, New York.

Mr. Ehrlich has experience as an accountant, an attorney and as an investment banker. He has been involved with public companies since the late 1960s, both as an investment banker and as the chief financial officer and a director of

Mattel, where he was instrumental in helping to uncover fraudulent practices in the preparation of certain of that company's financial statements, and he continued to serve as a director of Mattel through the late 1980s. After leaving Mattel, Mr. Ehrlich founded his own boutique investment banking company and became a director of certain of the companies involved in his investment banking business. Mr. Ehrlich ultimately became the Chairman and CEO of Fresenius USA, Inc. and of PSCX, prior to becoming our Chief Financial Officer in 1991 and our Chief Executive Officer in 2002. We believe that Mr. Ehrlich's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

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Steven Esses has been a director since July 2002, our Executive Vice President since January 2003, our Chief Operating Officer from February 2003 until February 2012 and our President since December 2005. From 2000 until 2002, Mr. Esses was a principal with Stillwater Capital Partners, Inc., a New York-based investment research and advisory company (hedge fund) specializing in alternative investment strategies. During this time, Mr. Esses also acted as an independent consultant to new and existing businesses in the areas of finance and business development. In 1995, Mr. Esses founded the Dunkin' Donuts franchise in Israel and was its Managing Director and CEO until 2005. Before founding Dunkin' Donuts Israel, Mr. Esses was the Director of Retail Jewelry Franchises with Hamilton Jewelry, and before that he served as Executive Director of Operations for the Conway Organization, a major off-price retailer with 17 locations.

Mr. Esses has been actively involved in the day-to-day management of companies since he was 22, when he co-founded a company that eventually went public. He has worked in retail and wholesale, in high-tech and low-tech, in a variety of industries. Throughout his career, he has been highly numbers-oriented, focusing on budgetary and fiscal matters and on building business value. We believe that Mr. Esses's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Dr. Jay M. Eastman has been one of our directors since October 1993. From 1991 to 2011, Dr. Eastman served as President and Chief Executive Officer of Lucid, Inc., a public company that is developing laser technology applications for medical diagnosis and treatment; since December 2011, Dr. Eastman has served as a director and Chief Science Officer of Lucid. Dr. Eastman served as Senior Vice President of Strategic Planning of PSCX from December 1995 through October 1997. Dr. Eastman is also a director of Dimension Technologies, Inc., a developer and manufacturer of 3D displays for computer and video displays. From 1981 until 1983, Dr. Eastman was the Director of the University of Rochester's Laboratory for Laser Energetics, where he was a member of the staff from 1975 to 1981. Dr. Eastman holds a B.S. and a Ph.D. in Optics from the University of Rochester in New York.

Dr. Eastman brings to our Board the unique perspective of a trained scientist who has also been deeply involved in the business world. Since many of our company's products are of a "high-tech" nature, Dr. Eastman's scientific background is extremely valuable to the Board. Additionally, Dr. Eastman brings to the Board his experiences as Chairman and Chief Executive Officer of a high-tech company, as well as his experience as a director of other public companies. We believe that Dr. Eastman's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Edward J. Borey has been one of our directors since December 2003. From July 2004 until October 2006, Mr. Borey served as Chairman and Chief Executive Officer of WatchGuard Technologies, Inc., a leading provider of network security solutions (NasdaqGM: WGRD). From December 2000 to September 2003, Mr. Borey served as President, Chief Executive Officer and a director of PSCX. Prior to joining PSCX, Mr. Borey was President and CEO of TranSenda (May 2000 to December 2000). Previously, Mr. Borey held senior positions in the automated data collection industry. At Intermec Technologies Corporation (1995-1999), he was Executive Vice President and Chief Operating Officer and also Senior Vice President/General Manager of the Intermec Media subsidiary. Mr. Borey holds a B.S. in Economics from the State University of New York, College of Oswego, an M.A. in Public Administration from the University of Oklahoma, and an M.B.A. in Finance from Santa Clara University.

Mr. Borey has served as the chief executive officer of two public companies and as chief operating officer of one public and one private company, some of which were very active in mergers and acquisitions. He has a wealth of experience in the issues facing public companies and businesses in general, including in turnaround situations, and he has strong experience in marketing in North America, Europe and Asia. His background also includes experience with support and maintenance of military ground vehicles and auxiliary ground vehicles, fixed and rotary aircraft, and simulation for the United States and foreign militaries. We believe that Mr. Borey's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Seymour Jones has been one of our directors since August 2005. Mr. Jones has been a clinical professor of accounting at New York University Stern School of Business since September 1993. Professor Jones teaches courses in accounting, tax, forensic accounting and legal aspects of entrepreneurship. He is also the Associate Director of Ross Institute of Accounting Research at Stern School of Business. His primary research areas include audit committees, auditing, entrepreneurship, financial reporting, and fraud. Professor Jones is the principal author of numerous books including Conflict of Interest, The Coopers & Lybrand Guide to Growing Your Business, The Emerging Business and The Bankers Guide to Audit Reports and Financial Statements. From April 1974 to September 1995, Mr. Jones was a senior partner of the accounting firm of Coopers & Lybrand, a legacy firm of PricewaterhouseCoopers LLP ("PwC"). Professor Jones is a certified public accountant in New York State. Professor Jones received a B.A. in economics from City College, City University of New York, and an M.B.A. from NYU Stern.

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Mr. Jones brings many years of experience as an audit partner at PwC with extensive financial accounting knowledge that is critical to our board of directors. Mr. Jones's experience with accounting principles, financial reporting rules and regulations, evaluating financial results and generally overseeing the financial reporting process of large public companies from an independent auditor's perspective and as a professor of accounting makes him an invaluable asset to our board of directors. We believe that Mr. Jones's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Elliot Sloyer has served as a director since October 2007. Mr. Sloyer is a Managing Member of WestLane Capital Management, LLC, which he founded in 2005. From 1992 until 2005, Mr. Sloyer was a founder and Managing Director of Harbor Capital Management, LLC, which managed convertible arbitrage portfolios. Mr. Sloyer is active in community organizations and currently serves on the investment committee of a charitable organization. Mr. Sloyer also serves as a director of Trans-Lux Corporation, a designer and manufacturer of digital signage display solutions (OTC: TNLX). Mr. Sloyer has a B.A. from New York University.

Mr. Sloyer's investment advisor experience brings valuable insight to the Board in enabling us to anticipate the reactions and concerns of the investment community. We believe that Mr. Sloyer's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Michael E. Marrus has been one of our directors since October 2007. Since October 2011, Mr. Marrus has been a Managing Director of Dominick & Dominick LLC, one of the oldest, privately-held investment firms in the United States. From 2009 to 2011, Mr. Marrus was a Managing Director of Merriman Curhan Ford, Inc., a financial services firm focused on growth companies. From 1998 to 2009, he was a Managing Director of C.E. Unterberg, Towbin & Co., an investment banking firm that was acquired by Collins Stewart plc. Prior to joining Unterberg, Towbin, Mr. Marrus was a Principal and founding member of Fieldstone Private Capital Group, an investment banking firm specializing in corporate, project and structured finance. Previously, he was employed at Bankers Trust Company, initially in the Private Equity and Merchant Banking Groups and subsequently in BT Securities, the securities affiliate of Bankers Trust. Mr. Marrus has an A.B. from Brown University and an M.B.A. from the Graduate School of Business, University of Chicago.

Mr. Marrus has been involved in mergers and acquisitions as an investment banker and has experience in company valuation in a wide range of industries, a critical skill set for us. We believe that Mr. Marrus's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Arthur S. Leibowitz has been one of our directors since June 2009. Mr. Leibowitz is a lecturer at Adelphi University School of Business where he teaches courses in accounting to both graduate and undergraduate students. Before joining Adelphi University, Mr. Leibowitz was an audit and business assurance partner at PwC. During his twenty-seven years at PwC, Mr. Leibowitz served in a national leadership role for PwC's retail industry group and was the portfolio audit partner for one of PwC's leading private equity firms. Mr. Leibowitz is a certified public accountant in New York State and received a B.S. in accounting from Brooklyn College in New York.

Mr. Leibowitz brings many years of experience as an audit and business assurance partner at PwC with extensive financial accounting knowledge that is critical to our board of directors. His skills are a vital asset to our board of directors at a time when accurate and transparent accounting, a sound financial footing and exemplary governance practices are essential. We believe that Mr. Leibowitz's background and experience make him appropriate to serve as one of our directors in light of our business and structure.

Thomas J. Paup has been our Vice President – Finance since December 2005 and our Chief Financial Officer since February 2006. Mr. Paup is currently also a Finance Lecturer at Eastern Michigan University. Mr. Paup was an Affiliated Partner with McMillan/Doolittle LLP from March 2002 until accepting this position with us, and prior

thereto, he was an Executive in Residence and Finance Instructor at DePaul University's Kellstadt Graduate School of Business. Prior to his teaching experience, Mr. Paup spent over 25 years in the retail industry. Most recently, between 1997 and 2000, Mr. Paup was the Executive Vice President and Chief Financial Officer and member of the Board of Directors of Montgomery Ward and Company. Mr. Paup brings a broad background of strategic and operational management experiences from the department store industry, where he served as CFO of Lord & Taylor and Kaufmann's and Controller of Bloomingdale's and Robinson-May. Mr. Paup holds an MBA in Finance and a BBS from Eastern Michigan University.



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### Board Leadership Structure

We have chosen to combine the positions of Chairman of the Board and Chief Executive Officer. We believe that Mr. Ehrlich's long experience in business, both as a director and as chairman of the board of other public companies, as well as his unique understanding of our business, make it desirable that he serve as Chairman of our Board of Directors, and that the size of our company and the nature of our business do not require that the positions of Chairman and of Chief Executive Officer be bifurcated.

Our independent directors have not chosen to formally designate one of their number as lead independent director.

### Committees of the Board of Directors

Our board of directors has an Audit Committee, a Compensation Committee, a Nominating Committee and an Executive and Finance Committee.

Created in December 1993, the purpose of the Audit Committee is to review with management and our independent auditors the scope and results of the annual audit, the nature of any other services provided by the independent auditors, changes in the accounting principles applied to the presentation of our financial statements, and any comments by the independent auditors on our policies and procedures with respect to internal accounting, auditing and financial controls. The Audit Committee was established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended. In addition, the Audit Committee is charged with the responsibility for making decisions on the engagement of independent auditors. As required by law, the Audit Committee operates pursuant to a charter, available through a hyperlink located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>. The Audit Committee consists of Prof. Jones (Chair) and Messrs. Borey, Sloyer and Leibowitz. We have determined that each of Prof. Jones and Mr. Leibowitz qualifies as an "audit committee financial expert" under applicable SEC and Nasdaq regulations. Prof. Jones and Mr. Leibowitz, as well as all the other members of the Audit Committee, are "independent," as independence is defined in Rule 4200(a)(15) of the National Association of Securities Dealers' listing standards and under Item 7(d)(3)(iv) of Schedule 14A of the proxy rules under the Exchange Act.

The Compensation Committee, also created in December 1993, recommends annual compensation arrangements for the Chief Executive Officer and Chief Financial Officer and reviews annual compensation arrangements for all officers and significant employees. The Compensation Committee operates pursuant to a charter, available through a hyperlink located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>. The Compensation Committee consists of Dr. Eastman (Chair) and Messrs. Marrus and Sloyer, all of whom are independent non-employee directors.

The Executive and Finance Committee, created in July 2001, exercises the powers of the Board during the intervals between meetings of the Board, in the management of the property, business and affairs of the Company (except with respect to certain extraordinary transactions). The Executive and Finance Committee consists of Messrs. Ehrlich (Chair), Esses, Marrus and Sloyer.

The Nominating Committee, created in March 2003, identifies and proposes candidates to serve as members of the Board of Directors. Proposed nominees for membership on the Board of Directors submitted in writing by stockholders to the Secretary of the Company will be brought to the attention of the Nominating Committee. The Nominating Committee consists of Mr. Marrus (Chair), Dr. Eastman and Prof. Jones, all of whom are "independent," as independence is defined in Rule 4200(a)(15) of the National Association of Securities Dealers' listing standards and under Item 7(d)(3)(iv) of Schedule 14A of the proxy rules under the Exchange Act. The Nominating Committee operates under a formal charter that governs its duties. The Nominating Committee's charter is publicly available

through a hyperlink located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>.

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### Code of Ethics

We have adopted a Code of Ethics, as required by Nasdaq listing standards and the rules of the SEC, that applies to our principal executive officer, our principal financial officer and our principal accounting officer. The Code of Ethics is publicly available through a hyperlink located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>. If we make substantive amendments to the Code of Ethics or grant any waiver, including any implicit waiver, that applies to anyone subject to the Code of Ethics, we will disclose the nature of such amendment or waiver on the website or in a report on Form 8-K in accordance with applicable Nasdaq and SEC rules.

### Code of Conduct

We have adopted a general Code of Conduct, as required by Nasdaq listing standards and the rules of the SEC, that applies to all of our employees. The Code of Conduct is publicly available through a hyperlink located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>.

### Whistleblower Policy

We have adopted a Whistleblower Policy, as required by Nasdaq listing standards, in order to ensure compliance with the provisions of the Sarbanes-Oxley Act of 2002. The Whistleblower Policy is publicly available through a hyperlink located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>. Employees with complaints about our compliance with applicable legal and regulatory requirements relating to accounting, auditing and internal control matters may submit their complaints in person, by mail or other written communication or by telephone to our Complaint Administrator. The Complaint Administrator can be contacted anonymously, by submitting the form located on our corporate website at <http://arotech.com/compro/complaint.html>. Complaints sent in this manner will automatically be stripped of all computer-encoded information identifying the originating e-mail address, and will then automatically be forwarded to the Complaint Administrator's regular e-mail address at Arotech.

### Director Compensation

Non-employee members of our Board of Directors are entitled to a cash retainer in 2012 of \$3,500 (plus expenses) per quarter, plus \$500 per quarter for each committee on which such outside directors serve. (In 2011, the Directors were paid a cash retainer of \$7,000 per quarter but voluntarily accepted a reduced retainer in 2012 as an expense control measure.) The Chairman of the Audit Committee receives an additional retainer of \$1,500 per quarter, and the Chairman of the Compensation Committee receives an additional retainer of \$1,000 per quarter. No per-meeting fees are paid. In addition, we have adopted a Non-Employee Director Equity Compensation Plan, pursuant to which non-employee directors receive an initial grant of a number of restricted shares having a fair market value on the date of grant equal to \$25,000 upon their election as a director, and an annual grant on March 31 of each year of a number of restricted shares having a fair market value on the date of grant equal to \$15,000. Each grant of restricted stock shall become free of restrictions in three equal installments on each of the first, second and third anniversaries of the grant, unless the director resigns from the Board prior to such vesting. Restrictions lapse automatically in the event of a director being removed for service other than for cause, or being nominated as a director but failing to be elected, or death, disability or mandatory retirement. Furthermore, all restrictions lapse prior to the consummation of a merger or consolidation involving us, our liquidation or dissolution, any sale of substantially all of our assets or any other transaction or series of related transactions as a result of which a single person or several persons acting in concert own a majority of our then-outstanding common stock.



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The following table shows the compensation earned or received by each of our non-officer directors for the year ended December 31, 2012:

## DIRECTOR COMPENSATION

| Name                | Fees Earned<br>or Paid in<br>Cash | Stock<br>Awards<br>Granted<br>2012 | Total    | Stock<br>Awards<br>Vested(1)<br>2012 |     |
|---------------------|-----------------------------------|------------------------------------|----------|--------------------------------------|-----|
| Dr. Jay M. Eastman  | \$23,500                          | \$15,000                           | \$38,500 | \$15,853                             | (2) |
| Edward J. Borey     | \$21,500                          | \$15,000                           | \$36,500 | \$15,853                             | (3) |
| Seymour Jones       | \$25,500                          | \$15,000                           | \$40,500 | \$15,853                             | (4) |
| Elliot Sloyer       | \$23,500                          | \$15,000                           | \$38,500 | \$15,853                             | (5) |
| Michael E. Marrus   | \$23,500                          | \$15,000                           | \$38,500 | \$15,853                             | (6) |
| Arthur S. Leibowitz | \$19,500                          | \$15,000                           | \$34,500 | \$12,759                             | (7) |

- (1) This column reflects the 2012 compensation expense for stock based awards for the year ended December 31, 2012.
- (2) As of December 31, 2012, Dr. Eastman held 22,146 unvested restricted shares of our common stock.
- (3) As of December 31, 2012, Mr. Borey held 22,146 unvested restricted shares of our common stock.
- (4) As of December 31, 2012, Prof. Jones held 22,146 unvested restricted shares of our common stock.
- (5) As of December 31, 2012, Mr. Sloyer held 22,146 unvested restricted shares of our common stock.
- (6) As of December 31, 2012, Mr. Marrus held 22,146 unvested restricted shares of our common stock.
- (7) As of December 31, 2012, Mr. Leibowitz held 22,146 unvested restricted shares of our common stock.

## Significant Employees

Our significant employees as of February 28, 2013, and their ages as of December 31, 2012, are as follows:

| Name              | Age | Position   |
|-------------------|-----|--|
| Dean Krutty       | 47  | President, Training and Simulation Division          |
| Ronen Badichi     | 47  | President, Battery and Power Systems Division        |
| Yaakov Har-Oz     | 55  | Senior Vice President, General Counsel and Secretary |
| Norman E. Johnson | 60  | Corporate Controller, Chief Accounting Officer       |

Dean Krutty became President of the Simulation Division in January 2005, after having spent the prior thirteen years as a member of the FAAC management team. He began his career at FAAC as an electrical engineer in FAAC's part task trainer division and most recently served as FAAC's Director of Military Operations. He also has significant experience managing programs in the training and simulation industry. Mr. Krutty holds a B.S. in electrical engineering from the Michigan State University.

Ronen Badichi became the General Manager of Epsilon Electronic Industries in May 2005 and the President of our Battery Division in December 2007. Prior to joining Epsilon, Mr. Badichi served since 1999 as the General Manager of Maoz Industries, a high end supplier of displays to the aviation industry. Prior thereto, Mr. Badichi was a project manager at BAE Systems and served as the F-16 Avionics Integration manager in the Israeli Air Force, with the rank of Captain. Mr. Badichi holds a B.Sc. in Physics and Electro-Optic Engineering from the Lev Institute of Technology in Jerusalem.

Yaakov Har-Oz has served as our Vice President and General Counsel since October 2000 and as our corporate Secretary since December 2000; in December 2005 Mr. Har-Oz was promoted to Senior Vice President. From 1994 until October 2000, Mr. Har-Oz was a partner in the Jerusalem law firm of Ben-Ze'ev, Hacoheh & Co. Prior to moving to Israel in 1993, he was an administrative law judge and in private law practice in New York. Mr. Har-Oz holds a B.A. from Brandeis University in Waltham, Massachusetts and a J.D. from Vanderbilt Law School (where he was an editor of the law review) in Nashville, Tennessee. He is a member of the New York bar and the Israel Chamber of Ad-vocates.

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Norman E. Johnson has served as our Controller and as our Chief Accounting Officer since August 2006. Prior to joining Arotech, Mr. Johnson was the Corporate Controller with Catuity Inc., a Nasdaq-listed provider of loyalty and gift card solutions. Prior to Catuity, he was with the McCoig Group, a Detroit based holding company, and from March 2000 to August 2004 he was the Corporate Controller of Learning Care Group Inc., a \$250 million Nasdaq-listed provider of child care and educational services. Mr. Johnson holds a B.S. in Accounting from Central Michigan University in Mt. Pleasant, Michigan.

## Section 16(a) Beneficial Ownership Reporting Compliance

Under the securities laws of the United States, our directors, certain of our officers and any persons holding more than ten percent of our common stock are required to report their ownership of our common stock and any changes in that ownership to the Securities and Exchange Commission. Specific due dates for these reports have been established and we are required to report any failure to file by these dates during 2012. We are not aware of any instances during 2012, not previously disclosed by us, where such “reporting persons” failed to file the required reports on or before the specified dates, except as follows:

- (i) Mr. Paup was required to file a Form 4 on or prior to December 21, 2012 in connection with his exercise of 5,555 Restricted Stock Units. He reported these transactions in a Form 5 filed on February 14, 2013.

## ITEM 11. EXECUTIVE COMPENSATION

## Cash and Other Compensation

## Summary Compensation Table

The following table, which should be read in conjunction with the explanations provided below, shows the compensation that we paid (or accrued) to our executive officers during the fiscal years ended December 31, 2012 and 2011:

SUMMARY COMPENSATION TABLE(1)

| Name and<br>Principal<br>Position   | Year | Salary         | Bonus      | Stock<br>Awards<br>Granted(2) | All Other<br>Compensation | Total        |
|---|------|----------------|------------|-------------------------------|---------------------------|--------------|
| Robert S. Ehrlich<br>Chairman, Chief<br>Executive<br>Officer and a<br>director  | 2012 | \$ 431,910     | \$ 120,533 | \$ 230,000                    | \$ 90,361 (3)             | \$ 872,804   |
|   | 2011 | \$ 502,583     | \$ 180,000 | \$ 262,000                    | \$ 150,148 (4)            | \$ 1,094,731 |
| Thomas J. Paup<br>Vice President –<br>Finance and<br>Chief Financial<br>Officer | 2012 | \$ 175,000     | \$ 68,805  | \$ 72,000                     | \$ (3,137) (5)            | \$ 312,668   |
|   | 2011 | \$ 190,000     | \$ 47,641  | \$ 157,200                    | \$ 4,675 (5)              | \$ 399,516   |
| Steven Esses<br>President and a<br>director                                     | 2012 | \$ 232,566 (6) | \$ 145,200 | \$ 172,500                    | \$ 386,851 (7)            | \$ 903,279   |
|   | 2011 | \$ 239,856 (8) | \$ 143,661 | \$ 196,500                    | \$ 352,182 (9)            | \$ 883,242   |

(1)

We paid the amounts reported for each named executive officer in U.S. dollars and/or New Israeli Shekels (NIS). We have translated amounts paid in NIS into U.S. dollars at the exchange rate of NIS into U.S. dollars at the time of payment or accrual, except that certain items are pursuant to corporate policy paid at a set exchange rate that may be higher than the actual exchange rate on the date of payment. The difference, which was a positive number in 2011 and 2012, has been reported under "Salary." The exchange rate differences for Mr. Ehrlich were \$62,843 and \$102,583 for 2012 and 2011, respectively. The exchange rate differences for Mr. Esses were \$33,838 and \$48,957 for 2012 and 2011, respectively. Additionally, Mr. Ehrlich and Mr. Paup voluntarily reduced their salary in the 2nd quarter of 2012 as a cost control measure.



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- (2) Reflects the value of awards of restricted stock or restricted stock units granted to our executive officers based on the compensation cost of their stock-based awards – see Note 13.c. of the Notes to Consolidated Financial Statements. The number of shares of restricted stock or restricted stock units received by our executive officers pursuant to such awards in 2012 (in connection with their amended and restated employment agreements), vesting entirely after two years (dependent 33% on tenure and 67% on performance), was as follows: Mr. Ehrlich, 100,000; Mr. Esses, 75,000; Mr. Paup, 60,000. None of these shares came up for vesting in 2012. The number of shares of restricted stock or restricted stock units received by our executive officers pursuant to such awards in 2011, vesting one-half after one year (dependent 25% on tenure and 75% on performance) and one-half after two years (dependent 33% on tenure and 67% on performance), was as follows: Mr. Ehrlich, 100,000; Mr. Esses, 150,000; Mr. Paup, 120,000. The first tranche of these shares came up for vesting in December 2011, and of the 75% dependent on performance, one-third – or 25% of the total – vested; shares not vesting were cancelled. The second tranche of these shares came up for vesting in December 2012, and of the 67% dependent on performance, 156,667 shares – or 67% of the total – vested.
- (3) Of this amount, \$(31,467) (the obligation declined due to exchange rate differences) represents the change in our accrual for severance pay that will be payable to Mr. Ehrlich upon his leaving our employ other than if he is terminated for cause, such as a breach of trust; \$30,720 represents the change of our accrual for vacation pay; \$30,131 represents tax reimbursements and \$60,977 represents other normal or mandated Israeli benefits.
- (4) Of this amount, \$24,654 represents the change in our accrual for severance pay that will be payable to Mr. Ehrlich upon his leaving our employ other than if he is terminated for cause, such as a breach of trust; \$29,241 represents the change of our accrual for vacation pay; \$55,526 represents tax reimbursements and \$40,727 represents other normal or mandated Israeli benefits.
- (5) Represents the increase (decrease) in our accrual for Mr. Paup for accrued but unused vacation days.
- (6) Does not include approximately \$186,000 that we paid in consulting fees to Sampen Corporation, a New York corporation owned by members of Steven Esses's immediate family, from which Mr. Esses receives a salary. See "Item 13. Certain Relationships and Related Transactions – Consulting Agreement with Sampen Corporation," below.
- (7) Of this amount, \$33,102 represents payments to Israeli pension and education funds; \$232,066 represents the change in our accrual for severance pay that will be payable to Mr. Esses upon his leaving our employ other than if he is terminated for cause, such as a breach of trust; \$26,856 represents sick pay redemption; \$2,227 represents the change of our accrual for vacation pay; \$645 represents tax reimbursements; and \$58,117 represents other normal or mandated Israeli benefits.
- (8) Does not include \$185,856 that we paid in consulting fees to Sampen Corporation, a New York corporation owned by members of Steven Esses's immediate family, from which Mr. Esses receives a salary. See "Item 13. Certain Relationships and Related Transactions – Consulting Agreement with Sampen Corporation," below.
- (9) Of this amount, \$34,281 represents payments to Israeli pension and education funds; \$166,209 represents the change in our accrual for severance pay that will be payable to Mr. Esses upon his leaving our employ other than if he is terminated for cause, such as a breach of trust; \$27,256 represents sick pay redemption; \$15,896 represents

the change of our accrual for vacation pay; \$23,868 represents tax reimbursements; and \$35,715 represents other normal or mandated Israeli benefits.

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## Executive Loans

In 2000 and 2002, we extended certain loans to certain of our Named Executive Officers. These loans are summarized in the following table, and are further described under “Item 13. Certain Relationships and Related Transactions – Officer Loans,” below.

| Name of Borrower  | Date of Loan | Original<br>Principal<br>Amount of Loan | Amount<br>Outstanding<br>as of 12/31/2012 | Terms of Loan   |
|-------------------|--------------|---|---|---|
| Robert S. Ehrlich | 02/09/2000   | \$ 329,163                              | \$ 452,995                                | Twenty-five-year non-recourse loan to purchase our stock, secured by the shares of stock purchased. |
| Robert S. Ehrlich | 06/10/2002   | \$ 36,500                               | \$ –                                      | Ten-year non-recourse loan to purchase our stock, secured by the shares of stock purchased.         |

## Plan-Based Awards

## Grants of Stock Options

We did not grant any stock options to our executive officers during 2012.

## Grants of Restricted Stock or Restricted Stock Units

During 2012, the Compensation Committee approved the grant of a total of 235,000 shares of restricted stock or restricted stock units to our executive officers (in connection with their amended and restated employment agreements). The table below sets forth each equity award granted to our executive officers during the year ended December 31, 2012.

## GRANTS OF PLAN-BASED AWARDS

| Name                 | Grant Date | All Other Stock<br>Awards: Number<br>of Shares of<br>Stocks | Grant Date Fair<br>Value of Stock<br>Awards (1) |
|----------------------|------------|---|---|
| Robert S. Ehrlich(2) | 01/01/2012 | 100,000   | \$ 120,000                                      |
| Robert S. Ehrlich(3) | 11/12/2012 | 100,000   | \$ 110,000                                      |
| Steven Esses(2)      | 01/01/2012 | 75,000  | \$ 90,000                                       |
| Steven Esses(3)      | 11/12/2012 | 75,000  | \$ 82,500                                       |
| Thomas J. Paup(2)    | 01/01/2012 | 60,000  | \$ 79,800                                       |

- (1) Reflects the aggregate market value of the shares of restricted stock or restricted stock units determined based on the closing price of our common stock on the Nasdaq Global Market on the date of grant.
- (2) The restricted shares or restricted stock units vest entirely after two years, in December 2013 (dependent 33% on tenure and 67% on performance).
- (3) The restricted shares vest equally over three years starting in June 2013.

## Stock Option Exercises and Vesting of Restricted Stock Awards

Our executive officers did not exercise any stock options during 2012. The following table presents awards of restricted stock or restricted stock units that vested during the year ended December 31, 2012.

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## STOCK VESTED

| Name              | Number of<br>Shares<br>Acquired on<br>Vesting<br>(#) | Value<br>Realized<br>on Vesting(1)<br>(\$) |
|-------------------|--|--|
| Robert S. Ehrlich | 100,000  | \$ 103,000                                 |
| Steven Esses      | 75,000   | \$ 77,250                                  |
| Thomas J. Paup    | 60,000   | \$ 61,800                                  |

(1) Reflects the aggregate market value of the shares of restricted stock or restricted stock units determined based on a per share price of \$1.03, the closing price of our common stock on the Nasdaq Global Market on December 31, 2012, which was the last trading day of 2012.

## Outstanding Equity Awards at Fiscal Year-End

The table below sets forth information for our executive officers with respect to option, restricted stock and restricted stock unit values at the end of the fiscal year ended December 31, 2012.

## OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

| Name              | Stock Awards  |   |   |   |
|-------------------|---|---|---|---|
|                   |   |   | Equity Incentive<br>Plan Awards                                   |   |
|                   | Number of<br>Shares that<br>Have Not<br>Vested<br>(#) | Market Value<br>of Shares that<br>Have Not<br>Vested(1)<br>(\$) | Number of<br>Unearned<br>Shares that<br>Have Not<br>Vested<br>(#) | Market Value<br>of Unearned<br>Shares that<br>Have Not<br>Vested(1)<br>(\$) |
| Robert S. Ehrlich | 133,334   | \$ 137,334  | 66,666  | \$ 68,666   |
| Steven Esses      | 100,000   | \$ 103,000  | 50,000  | \$ 51,500   |
| Thomas J. Paup    | 20,000  | \$ 20,600   | 40,000  | \$ 41,200   |

(1) Reflects the aggregate market value of the shares of restricted stock or restricted stock units determined based on a per share price of \$1.03, the closing price of our common stock on the Nasdaq Global Market on December 31, 2012, which was the last trading day of 2012.

## Employment Contracts

## Robert S. Ehrlich

Mr. Ehrlich is party to an amended and restated employment agreement with us executed in February 2012. The term of this employment agreement expires on December 31, 2013.

The employment agreement provides for a base salary of NIS 150,000 (approximately \$39,400 per month based on the exchange rate on January 1, 2012), as adjusted annually for Israeli inflation. Additionally, the board may at its

discretion raise Mr. Ehrlich's base salary. The employment agreement also granted Mr. Ehrlich a retention bonus in the amount of 100,000 shares of restricted stock, which vests on December 31, 2013, with such vesting being contingent on Mr. Ehrlich being employed by us on the scheduled vesting date and on performance criteria to be established by the Compensation Committee of our Board of Directors.

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The employment agreement provides that we will pay an annual bonus, on a sliding scale, in an amount equal to 35% of Mr. Ehrlich's annual base salary then in effect if the results we actually attain for the year in question are 90% or more of the amount we budgeted at the beginning of the year, up to a maximum of 75% of his annual base salary then in effect if the results we actually attain for the year in question are 120% or more of the amount we budgeted at the beginning of the year. Mr. Ehrlich's previous employment agreement had an identical bonus provision. For 2011 and 2012, the Compensation Committee choose financial targets for determining eligibility for the above-referenced cash incentive bonus that are determined in part on the achievement of set budgetary forecast targets for adjusted EBITDA, a non-GAAP measurement, and in part on the achievement of other targets – in the case of 2011, targets for backlog, and in the case of 2012, targets for revenues. The Board's adjusted budget for 2012 for continuing operations called for adjusted EBITDA of \$2.39 million with revenues of at least \$79 million. Actual results were EBITDA of \$2.64 million with revenues of \$80.1 million. New bonus targets will be chosen for 2013 based upon future budgetary forecasts.

The employment agreement also contains various benefits customary in Israel for senior executives, tax and financial planning expenses and an automobile, and contain confidentiality and non-competition covenants. Pursuant to the employment agreements, we granted Mr. Ehrlich demand and "piggyback" registration rights covering shares of our common stock held by him.

We can terminate Mr. Ehrlich's employment agreement in the event of death or disability or for "Cause" (defined as conviction of certain crimes, willful failure to carry out directives of our board of directors or gross negligence or willful misconduct). Mr. Ehrlich has the right to terminate his employment upon a change in our control or for "Good Reason," which is defined to include adverse changes in employment status or compensation, our insolvency, material breaches and certain other events. Additionally, Mr. Ehrlich may terminate his agreement for any reason upon 120 days' notice.

Upon termination of employment, the employment agreement provides for payment of all accrued and unpaid compensation and benefits (including under most circumstances Israeli statutory severance, described under "Item 1. Business – Employees," above), and (unless we have terminated the agreement for Cause or Mr. Ehrlich has terminated the agreement without Good Reason and without giving us 120 days' notice of termination) bonuses (to the extent earned) due for the year in which employment is terminated and severance pay in the amount of up to \$1,625,400. Furthermore, in respect of any termination by us other than termination for Cause or termination of the agreement due to Mr. Ehrlich's death or disability, or by Mr. Ehrlich other than for Good Reason, all outstanding options and all restricted shares will be fully vested. Restricted shares that have vested prior to the date of termination are not forfeited under any circumstances, including termination for Cause.

A table describing the payments that would have been due to Mr. Ehrlich under his employment agreement had Mr. Ehrlich's employment with us been terminated at the end of 2012 under various circumstances (pursuant to the terms of his then-current employment agreement) appears under "Potential Payments and Benefits upon Termination of Employment – Robert S. Ehrlich," below.

In April 2009, we, with the agreement of Mr. Ehrlich, funded a portion of his severance security by means of issuing to him, in trust, restricted stock having a value (based on the closing price of our stock on the Nasdaq Stock Market on the date on which Mr. Ehrlich and our board of directors agreed on this arrangement) of \$240,000, a total of 328,767 shares. We agreed with Mr. Ehrlich that the economic risk of gain or loss on these shares is to be borne by Mr. Ehrlich. Should Mr. Ehrlich leave our employ under circumstances in which he is not entitled to his severance package (primarily, termination for Cause as defined in his employment agreement), these shares would be returned to us for cancellation.

Steven Esses

Mr. Esses is party to an amended and restated employment agreement with EFL and guaranteed by us executed in February 2012. The term of this employment agreement expires on December 31, 2013.

The employment agreement provides for a base salary in 2012 of NIS 71,587 per month (approximately \$18,800 at the rate of exchange in effect on January 1, 2012), and a base salary in 2013 of NIS 129,187 per month (approximately \$33,900 at the rate of exchange in effect on January 1, 2012), as adjusted for Israeli inflation during 2012.

Additionally, the board may at its discretion raise Mr. Esses's base salary. The agreement also provides for a stock retention bonus of 75,000 shares of restricted stock, which vests on December 31, 2013, with such vesting being contingent on Mr. Esses being employed by us on the scheduled vesting date and on performance criteria to be established by the Compensation Committee of our Board of Directors.



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The employment agreement provides that if the results we actually attain in a given year are at least 90% of the amount we budgeted at the beginning of the year, we will pay a bonus, on a sliding scale, in an amount equal to a minimum of 20% of Mr. Esses's annual base salary then in effect, up to a maximum of 75% of his annual base salary then in effect if the results we actually attain for the year in question are 120% or more of the amount we budgeted at the beginning of the year. Mr. Esses's previous employment agreement had an identical bonus provision. For 2011 and 2012, the Compensation Committee choose financial targets for determining eligibility for the above-referenced cash incentive bonus that are determined in part on the achievement of set budgetary forecast targets for adjusted EBITDA, a non-GAAP measurement, and in part on the achievement of other targets – in the case of 2011, targets for backlog, and in the case of 2012, targets for revenues. The Board's adjusted budget for 2012 for continuing operations called for adjusted EBITDA of \$2.39 million with revenues of at least \$79 million. Actual results were EBITDA of \$2.64 million with revenues of \$80.1 million. New bonus targets will be chosen for 2013 based upon future budgetary forecasts.

The employment agreement also contains various benefits customary in Israel for senior executives, tax and financial planning expenses and an automobile, and contain confidentiality and non-competition covenants. Pursuant to the employment agreements, we granted Mr. Esses demand and "piggyback" registration rights covering shares of our common stock held by him.

We can terminate Mr. Esses's employment agreement in the event of death or disability or for "Cause" (defined as conviction of certain crimes, willful failure to carry out directives of our board of directors or gross negligence or willful misconduct). Mr. Esses has the right to terminate his employment upon a change in our control or for "Good Reason," which is defined to include adverse changes in employment status or compensation, our insolvency, material breaches and certain other events. Additionally, Mr. Esses may retire (after age 65), retire early (after age 55) or terminate his agreement for any reason upon 150 days' notice.

Upon termination of employment, the employment agreement provides for payment of all accrued and unpaid compensation (including under most circumstances Israeli statutory severance, described under "Item 1. Business – Employees," above), and (unless we have terminated the agreement for Cause or Mr. Esses has terminated the agreement without Good Reason and without giving us 150 days' notice of termination) bonuses (to the extent earned) due for the year in which employment is terminated (in an amount of not less than 20% of base salary) and severance pay, as follows: (A) before the end of the first year of the agreement, a total of (i) \$307,200 plus (ii) twenty-four (24) times monthly salary; or (B) at or after the end of the first year of the agreement, twenty-four (24) times monthly salary. Furthermore, Mr. Esses will receive, in respect of all benefits, an additional sum in the amount of (i) \$75,000, in the case of termination due to disability, Good Reason, death, or non-renewal, or (ii) \$150,000, in the case of termination due to early retirement, retirement, change of control or change of location. Additionally, in respect of any termination due to a change of control or a change in the primary location from which Mr. Esses shall have conducted his business activities during the 60 days prior to such change, all outstanding options and all restricted shares will be fully vested. Restricted shares that have vested prior to the date of termination are not forfeited under any circumstances, including termination for Cause.

A table describing the payments that would have been due to Mr. Esses under his employment agreement had Mr. Esses's employment with us been terminated at the end of 2012 under various circumstances (pursuant to the terms of his then-current employment agreement) appears under "Potential Payments and Benefits upon Termination of Employment – Steven Esses," below.

In April 2009, we, with the agreement of Mr. Esses, funded a portion of his severance security by means of issuing to him, in trust, restricted stock having a value (based on the closing price of our stock on the Nasdaq Stock Market on the date on which Mr. Esses and our board of directors agreed on this arrangement) of \$200,000, a total of 273,973 shares. We agreed with Mr. Esses that the economic risk of gain or loss on these shares is to be borne by Mr. Esses.

Should Mr. Esses leave our employ under circumstances in which he is not entitled to his severance package (primarily, termination for Cause as defined in his employment agreement), these shares would be returned to us for cancellation.

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See also “Item 13. Certain Relationships and Related Transactions – Consulting Agreement with Sampen Corporation,” below.

### Thomas J. Paup

Mr. Paup is party to an amended and restated employment agreement with us executed in February 2012, having a term running until December 31, 2014. Under the terms of his employment agreement, Mr. Paup is entitled to receive a base salary of \$190,000 per annum, as adjusted annually for inflation. The agreement also provides for a stock retention bonus of 60,000 shares of restricted stock, which vests on December 31, 2013, with such vesting being contingent on Mr. Paup being employed by us on the scheduled vesting date and on performance criteria to be established by the Compensation Committee of our Board of Directors.

The employment agreement provides that if the results we actually attain in a given year are at least 90% of the amount we budgeted at the beginning of the year, we will pay a bonus, on a sliding scale, in an amount equal to a minimum of 20% of Mr. Paup’s annual base salary then in effect, up to a maximum of 50% of his annual base salary then in effect if the results we actually attain for the year in question are 120% or more of the amount we budgeted at the beginning of the year. Mr. Paup’s previous employment agreement had an identical bonus provision. For 2011 and 2012, the Compensation Committee choose financial targets for determining eligibility for the above-referenced cash incentive bonus that are determined in part on the achievement of set budgetary forecast targets for adjusted EBITDA, a non-GAAP measurement, and in part on the achievement of other targets – in the case of 2011, targets for backlog, and in the case of 2012, targets for revenues. The Board’s adjusted budget for 2012 for continuing operations called for adjusted EBITDA of \$2.39 million with revenues of at least \$79 million. Actual results were EBITDA of \$2.64 million with revenues of \$80.1 million. New bonus targets will be chosen for 2013 based upon future budgetary forecasts.

Mr. Paup’s employment agreement provides that if we terminate his agreement other than for cause (defined as conviction of certain crimes, willful failure to carry out directives of our board of directors or gross negligence or willful misconduct), we must pay Mr. Paup severance in an amount of twelve times his monthly salary (doubled in the event of termination by reason of a change of control), with an additional three months’ severance payable if Mr. Paup completes the three-year term of his agreement. Additionally, in respect of any termination due to a change of control, all outstanding options and all restricted shares will be fully vested. Restricted shares that have vested prior to the date of termination are not forfeited under any circumstances, including termination for Cause.

A table describing the payments that would have been due to Mr. Paup under his employment agreement had Mr. Paup’s employment with us been terminated at the end of 2012 under various circumstances (pursuant to the terms of his then-current employment agreement) appears under “Potential Payments and Benefits upon Termination of Employment – Thomas J. Paup,” below.

### Others

Other employees have entered into individual employment agreements with us. These agreements govern the basic terms of the individual’s employment, such as salary, vacation, overtime pay, severance arrangements and pension plans. Subject to Israeli law, which restricts a company’s right to relocate an employee to a work site farther than sixty kilometers from his or her regular work site, we have retained the right to transfer certain employees to other locations and/or positions provided that such transfers do not result in a decrease in salary or benefits. All of these agreements also contain provisions governing the confidentiality of information and ownership of intellectual property learned or created during the course of the employee’s tenure with us. Under the terms of these provisions, employees must keep confidential all information regarding our operations (other than information which is already publicly available) received or learned by the employee during the course of employment. This provision remains in force for five years

after the employee has left our service. Further, intellectual property created during the course of the employment relationship belongs to us.

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A number of the individual employment agreements, but not all, contain non-competition provisions which restrict the employee's rights to compete against us or work for an enterprise which competes against us. Such provisions generally remain in force for a period of two years after the employee has left our service.

Under the laws of Israel, an employee of ours who has been dismissed from service, died in service, retired from service upon attaining retirement age, or left due to poor health, maternity or certain other reasons, is entitled to severance pay at the rate of one month's salary for each year of service, pro rata for partial years of service. We currently fund this obligation by making monthly payments to approved private provident funds and by its accrual for severance pay in the consolidated financial statements. See Note 2.q. of the Notes to the Consolidated Financial Statements.

### Potential Payments and Benefits upon Termination of Employment

This section sets forth in tabular form quantitative disclosure regarding estimated payments and other benefits that would have been received by certain of our executive officers if their employment had terminated on December 31, 2012 (the last business day of the fiscal year), pursuant to the terms of their then-current employment agreements.

For a narrative description of the severance and change in control arrangements in the current employment contracts of Messrs. Ehrlich, Esses and Paup, see "– Employment Contracts," above. Each of Messrs. Ehrlich and Esses will be eligible to receive severance payments in excess of accrued but unpaid items only if he signs a general release of claims.

Robert S. Ehrlich

The following table describes the potential payments and benefits upon employment termination for Robert S. Ehrlich, our Chairman and Chief Executive Officer, pursuant to applicable law and the terms of his then-current employment agreement with us, as if his employment had terminated on December 31, 2012 (the last business day of the fiscal year) under the various scenarios described in the column headings as explained in the footnotes below.

| ROBERT S. EHRLICH            |                        |           |                |                      |                        |                               |
|------------------------------|------------------------|-----------|----------------|----------------------|------------------------|-------------------------------|
| Payments and Benefits        | Death or Disability(1) | Cause(2)  | Good Reason(3) | Change of Control(4) | Termination at Will(5) | Other Employee Termination(6) |
| Accrued but unpaid:          |                        |           |                |                      |                        |                               |
| Base salary                  | \$ 29,644              | \$ 29,644 | \$ 29,644      | \$ 29,644            | \$ 29,644              | \$ 29,644                     |
| Vacation                     | 109,881                | 109,881   | 109,881        | 109,881              | 109,881                | 109,881                       |
| Recovery pay(7)              | 395                    | 395       | 395            | 395                  | 395                    | 395                           |
| Benefits:                    |                        |           |                |                      |                        |                               |
| Continuing education fund(8) | 2,223                  | 2,223     | 2,223          | 2,223                | 2,223                  | 2,223                         |
| Tax gross-up on automobile   | 2,621                  | –         | 2,621          | 2,621                | 2,621                  | –                             |
| Contractual severance        | 1,625,400              | –         | 1,625,400      | 1,625,400            | 1,625,400              | –                             |
| Statutory severance(9)       | 872,540                | –         | 872,540        | 872,540              | 872,540                | –                             |
|                              | 230,000                | –         | 230,000        | 230,000              | –                      | –                             |

Accelerated vesting  
of restricted stock

|        |              |            |              |              |              |            |
|--------|--------------|------------|--------------|--------------|--------------|------------|
| TOTAL: | \$ 2,872,704 | \$ 142,143 | \$ 2,872,704 | \$ 2,872,704 | \$ 2,642,704 | \$ 142,143 |
|--------|--------------|------------|--------------|--------------|--------------|------------|

(1)“Disability” is defined in Mr. Ehrlich’s employment agreement as a physical or mental infirmity which impairs Mr. Ehrlich’s ability to substantially perform his duties and which continues for a period of at least 180 consecutive days.

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- (2)“Cause” is defined in Mr. Ehrlich’s employment agreement as (i) conviction for fraud, crimes of moral turpitude or other conduct which reflects on us in a material and adverse manner; (ii) a willful failure to carry out a material directive of our Board of Directors, provided that such directive concerned matters within the scope of Mr. Ehrlich’s duties, would not give Mr. Ehrlich “Good Reason” to terminate his agreement (see footnote 4 below) and was capable of being reasonably and lawfully performed; (iii) conviction in a court of competent jurisdiction for embezzlement of our funds; and (iv) reckless or willful misconduct that is materially harmful to us.
- (3)“Good Reason” is defined in Mr. Ehrlich’s employment agreement as (i) a change in Mr. Ehrlich’s status, title, position or responsibilities which, in Mr. Ehrlich’s reasonable judgment, represents a reduction or demotion in his status, title, position or responsibilities as in effect immediately prior thereto; (ii) a reduction in Mr. Ehrlich’s base salary; (iii) the failure by us to continue in effect any material compensation or benefit plan in which Mr. Ehrlich is participating; (iv) our insolvency or the filing (by any party, including us) of a petition for our winding-up; (v) any material breach by us of any provision of Mr. Ehrlich’s employment agreement; (vi) any purported termination of Mr. Ehrlich’s employment for cause by us which does not comply with the terms of Mr. Ehrlich’s employment agreement; and (vii) any movement of the location where Mr. Ehrlich is generally to render his services to us from the Jerusalem/Tel Aviv area of Israel.
- (4)“Change of Control” is defined in Mr. Ehrlich’s employment agreement as (i) the acquisition (other than from us in any public offering or private placement of equity securities) by any person or entity of beneficial ownership of 20% or more of the combined voting power of our then-outstanding voting securities; or (ii) individuals who, as of January 1, 2000, were members of our Board of Directors (the “Original Board”), together with individuals approved by a vote of at least 2/3 of the individuals who were members of the Original Board and are then still members of our Board, cease for any reason to constitute at least 1/3 of our Board; or (iii) approval by our shareholders of a complete winding-up or an agreement for the sale or other disposition of all or substantially all of our assets.
- (5)“Termination at Will” is defined in Mr. Ehrlich’s employment agreement as Mr. Ehrlich terminating his employment with us on written notice of at least 120 days in advance of the effective date of such termination.
- (6)“Other Employee Termination” means a termination by Mr. Ehrlich of his employment without giving us the advance notice of 120 days needed to make such a termination qualify as a “Termination at Will.”
- (7)Pursuant to Israeli law and our customary practice, we pay Mr. Ehrlich in July of each year the equivalent of ten days’ “recuperation pay” at the statutory rate of NIS 371 (approximately \$99) per day.
- (8)Pursuant to Israeli law, we must contribute an amount equal to 7.5% of Mr. Ehrlich’s base salary to a continuing education fund, up to the permissible tax-exempt salary ceiling according to the income tax regulations in effect from time to time. At December 31, 2012, the ceiling then in effect was NIS 15,712 (approximately \$4,209). In Mr. Ehrlich’s case, we have customarily contributed to his continuing education fund in excess of the tax-exempt ceiling, and then reimbursed Mr. Ehrlich for the tax. The sums in the table reflect this additional contribution and the resultant tax reimbursement.
- (9)Under Israeli law, employees terminated other than for cause receive severance in the amount of one month’s base salary for each year of work, at their salary rate at the date

of termination.

Steven Esses

The following table describes the potential payments and benefits upon employment termination for Steven Esses, our President, pursuant to applicable law and the terms of his then-current employment agreement with us, as if his employment had terminated on December 31, 2012 (the last business day of the fiscal year) under the various scenarios described in the column headings as explained in the footnotes below.

See also “Item 13. Certain Relationships and Related Transactions – Consulting Agreement with Sampen Corporation,” below.



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## STEVEN ESSES

| Payments and<br>Benefits<br>Accrued but<br>unpaid(10): | Non-<br>Renewal(1) | Death or<br>Disability(2) | Cause(3)  | Good<br>Reason(4) | Change of<br>Control(5) | Change of<br>Location(6) | Retirement(7) | Early<br>Retirement(8) | Other<br>Employment(9) |
|--|--------------------|---------------------------|-----------|-------------------|-------------------------|--------------------------|---------------|------------------------|------------------------|
| Base salary  | \$19,961           | \$19,961                  | \$19,961  | \$19,961          | \$19,961                | \$19,961                 | \$19,961      | \$19,961               | \$19,961               |
| Vacation   | 88,214             | 88,214                    | 88,214    | 88,214            | 88,214                  | 88,214                   | 88,214        | 88,214                 | 88,214                 |
| S i c k<br>leave(11)                                   | 17,455             | 17,455                    | 17,455    | 17,455            | 17,455                  | 17,455                   | 17,455        | 17,455                 | 17,455                 |
| Recuperation<br>pay(12)                                | 277                | 277                       | 277       | 277               | 277                     | 277                      | 277           | 277                    | 277                    |
| Benefits:  |                    |                           |           |                   |                         |                          |               |                        |                        |
| M a n a g e r ' s<br>insurance(13)                     | 3,161              | 3,161                     | 3,161     | 3,161             | 3,161                   | 3,161                    | 3,161         | 3,161                  | 3,161                  |
| C o n t i n u i n g<br>e d u c a t i o n<br>fund(14)   | 1,497              | 1,497                     | 1,497     | 1,497             | 1,497                   | 1,497                    | 1,497         | 1,497                  | 1,497                  |
| Contractual<br>severance                               | 861,068            | 861,068                   | —         | 861,068           | 861,068                 | 861,068                  | 861,068       | 861,068                | —                      |
| S t a t u t o r y<br>severance(15)                     | 177,155            | 177,155                   | —         | 177,155           | 177,155                 | 177,155                  | 177,155       | 177,155                | —                      |
| Benefits   | —                  | —                         | —         | 75,000            | 150,000                 | 150,000                  | 150,000       | 150,000                | —                      |
| TOTAL:   | \$1,168,788        | \$1,168,788               | \$130,565 | \$1,243,788       | \$1,318,788             | \$1,318,788              | \$1,318,788   | \$1,318,788            | \$130,565              |

(1)“Non-renewal” is defined in Mr. Esses’s employment agreement as a decision, made with written notice of at least 90 days in advance of the effective date of such decision, by either us or Mr. Esses not to renew Mr. Esses’s employment for an additional two-year term. Pursuant to the terms of Mr. Esses’s employment agreement, in the absence of such notice, Mr. Esses’s employment agreement automatically renews.

(2)“Disability” is defined in Mr. Esses’s employment agreement as a physical or mental infirmity which impairs Mr. Esses’s ability to substantially perform his duties and which continues for a period of at least 180 consecutive days.

(3)“Cause” is defined in Mr. Esses’s employment agreement as (i) conviction for fraud, crimes of moral turpitude or other conduct which reflects on us in a material and adverse manner; (ii) a willful failure to carry out a material directive of our Chief Executive Officer, provided that such directive concerned matters within the scope of Mr. Esses’s duties, would not give Mr. Esses “Good Reason” to terminate his agreement (see footnote 4 below) and was capable of being reasonably and lawfully performed; (iii) conviction in a court of competent jurisdiction for embezzlement of our funds; and (iv) reckless or willful misconduct that is materially harmful to us.

(4)“Good Reason” is defined in Mr. Esses’s employment agreement as (i) a change in (a) Mr. Esses’s status, title, position or responsibilities which, in Mr. Esses’s reasonable judgment, represents a reduction or demotion in his status, title, position or responsibilities as in effect immediately prior thereto, or (b) in the primary location from which Mr. Esses shall have conducted his business activities during the 60 days prior to such change; or (ii) a reduction in Mr. Esses’s base salary; (iii) the failure by us to continue in effect any material compensation or benefit plan in which Mr. Esses is participating; (iv) our insolvency or the filing (by any party, including us) of a petition for our winding-up; (v) any material breach by us of any provision of Mr. Esses’s employment agreement; and (vi) any purported termination of Mr. Esses’s employment for cause by us which does not comply with the terms of Mr. Esses’s employment agreement.

(5)“Change of Control” is defined in Mr. Esses’s employment agreement as (i) the acquisition (other than from us in any public offering or private placement of equity securities) by any person or entity of beneficial ownership of

30% or more of the combined voting power of our then-outstanding voting securities; or (ii) individuals who, as of January 1, 2000, were members of our Board of Directors (the “Original Board”), together with individuals approved by a vote of at least 2/3 of the individuals who were members of the Original Board and are then still members of our Board, cease for any reason to constitute at least 1/3 of our Board; or (iii) approval by our shareholders of a complete winding-up or an agreement for the sale or other disposition of all or substantially all of our assets.

- (6) “Change of location” is defined in Mr. Esses’s employment agreement as a change in the primary location from which Mr. Esses shall have conducted his business activities during the 60 days prior to such change.
- (7) “Retirement” is defined as Mr. Esses terminating his employment with us at age 65 or older on at least 150 days’ prior notice.
- (8) “Early Retirement” is defined as Mr. Esses terminating his employment with us at age 55 or older (up to age 65) on at least 150 days’ prior notice.
- (9) Any termination by Mr. Esses of his employment with us that does not fit into any of the prior categories, including but not limited to Mr. Esses terminating his employment with us, with or without notice, other than at the end of an employment term or renewal thereof, in circumstances that do not fit into any of the prior categories.
- (10) Does not include a total of \$186,000 in accrued but unpaid consulting fees due at December 31, 2012 to Sampen Corporation, a New York corporation owned by members of Steven Esses’s immediate family, from which Mr. Esses receives a salary. See “Item 13. Certain Relationships and Related Transactions – Consulting Agreement with Sampen Corporation,” below.

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- (11)Limited to an aggregate of 30 days.
- (12)Pursuant to Israeli law and our customary practice, we pay Mr. Esses in July of each year the equivalent of six days' "recuperation pay" at the statutory rate of NIS 365 (approximately \$96) per day.
- (13)Payments to managers' insurance, a benefit customarily given to senior executives in Israel, come to a total of 15.83% of base salary, consisting of 8.33% for payments to a fund to secure payment of statutory severance obligations, 5% for pension and 2.5% for disability. The managers' insurance funds reflected in the table do not include the 8.33% payments to a fund to secure payment of statutory severance obligations with respect to amounts paid prior to December 31, 2011, which funds are reflected in the table under the "Statutory severance" heading.
- (14)Pursuant to Israeli law, we must contribute an amount equal to 7.5% of Mr. Esses's base salary to a continuing education fund, up to the permissible tax-exempt salary ceiling according to the income tax regulations in effect from time to time. At December 31, 2012, the ceiling then in effect was NIS 15,712 (approximately \$4,112). In Mr. Esses's case, we have customarily contributed to his continuing education fund in excess of the tax-exempt ceiling, and then reimbursed Mr. Esses for the tax. The sums in the table reflect this additional contribution and the resultant tax reimbursement.
- (15)Under Israeli law, employees terminated other than for cause receive severance in the amount of one month's base salary for each year of work, at their salary rate at the date of termination.

Thomas J. Paup

The following table describes the potential payments and benefits upon employment termination for Thomas J. Paup, our Vice President – Finance and Chief Financial Officer, pursuant to applicable law and the terms of his then-current employment agreement with us, as if his employment had terminated on December 31, 2012 (the last business day of the fiscal year) under the various scenarios described in the column headings as explained in the footnotes below.

| Payments and Benefits | THOMAS J. PAUP         |          |                      |                |                        |
|-----------------------|------------------------|----------|----------------------|----------------|------------------------|
|                       | Death or Disability(1) | Cause(2) | Change of Control(3) | Non-Renewal(4) | Termination at Will(5) |
| Accrued but unpaid:   |                        |          |                      |                |                        |
| Base salary           | \$7,491                | \$7,491  | \$7,491              | \$ 7,491       | \$7,491                |
| Vacation              | 8,060                  | 8,060    | 8,060                | 8,060          | 8,060                  |
| Contractual severance | –                      | –        | 380,000              | 190,000        | 47,500                 |
| TOTAL:                | \$15,551               | \$15,551 | \$395,551            | \$ 205,551     | \$63,051               |

- (1)"Disability" is defined in Mr. Paup's employment agreement as a physical or mental infirmity which impairs Mr. Paup's ability to substantially perform his duties and which continues for a period of at least 180 consecutive days.
- (2)"Cause" is defined in Mr. Paup's employment agreement as (i) a breach of trust by Mr. Paup, including, for example, but without limitation, commission of an act of moral turpitude, theft, embezzlement, self-dealing or insider trading; (ii) the unauthorized disclosure by Mr. Paup of confidential information of or relating to us; (iii) a material breach by Mr. Paup of his employment agreement; or (iv) any act of, or omission by, Mr. Paup which, in our reasonable judgment, amounts to a serious failure by Mr. Paup to perform his responsibilities or functions or in the exercise of his authority, which failure, in our reasonable judgment, rises to a level of gross nonfeasance, misfeasance or malfeasance.
- (3)"Change of Control" is defined in Mr. Paup's employment agreement as (i) the acquisition (other than from us in any public offering or private placement of equity securities) by any person or entity of beneficial ownership of 30% or more of the combined voting power of our then-outstanding voting securities; or (ii) individuals who, as of December 31, 2007, were

members of our Board of Directors (the “Original Board”), together with individuals approved by a vote of at least 2/3 of the individuals who were members of the Original Board and are then still members of our Board, cease for any reason to constitute at least 1/3 of our Board; or (iii) approval by our shareholders of a complete winding-up or an agreement for the sale or other disposition of all or substantially all of our assets.

- (4) “Non-Renewal” is defined in Mr. Paup’s employment agreement as the agreement coming to the end of the Term and not being extended or immediately succeeded by a new substantially similar employment agreement.
- (5) “Termination at Will” is defined in Mr. Paup’s employment agreement as Mr. Paup terminating his employment with us on written notice of at least 120 days in advance of the effective date of such termination.

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## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

## Security Ownership of Certain Beneficial Owners and Management

The following table sets forth information regarding the security ownership, as of February 28, 2013, of those persons owning of record or known by us to own beneficially more than 5% of our common stock and of each of our Named Executive Officers and directors, and the shares of common stock held by all of our directors and executive officers as a group.

| Name and Address of Beneficial Owner(1)                            | Shares<br>Beneficially<br>Owned(2)(3) | Percentage of<br>Total<br>Shares<br>Outstanding(3) |
|--|---------------------------------------|--|
| Robert S. Ehrlich  | 1,409,688 (4)                         | 8.7 %  |
| Steven Esses   | 995,480 (5)                           | 6.2 %  |
| Thomas J. Paup   | 293,596 (6)                           | 1.8 %  |
| Dr. Jay M. Eastman   | 61,193 (7)                            | *  |
| Edward J. Borey  | 62,335 (8)                            | *  |
| Prof. Seymour Jones  | 61,193 (9)                            | *  |
| Elliot Sloyer  | 192,918 (10)                          | 1.2 %  |
| Michael E. Marrus  | 64,483 (11)                           | *  |
| Arthur S. Leibowitz  | 46,502 (12)                           | *  |
| All of our directors and executive officers as a group (9 persons) | 3,147,388 (13)                        | 19.5 %   |

\* Less than one percent.

- (1) The address of each named beneficial owner is in care of Arotech Corporation, 1229 Oak Valley Drive, Ann Arbor, Michigan 48108.
- (2) Unless otherwise indicated in these footnotes, each of the persons or entities named in the table has sole voting and sole investment power with respect to all shares shown as beneficially owned by that person, subject to applicable community property laws.
- (3) Based on 16,174,187 shares of common stock outstanding as of February 28, 2013. For purposes of determining beneficial ownership of our common stock, owners of options exercisable within sixty days are considered to be the beneficial owners of the shares of common stock for which such securities are exercisable. The percentage ownership of the outstanding common stock reported herein is based on the assumption (expressly required by the applicable rules of the Securities and Exchange Commission) that only the person whose ownership is being reported has exercised his options for shares of common stock.
- (4) Consists of 899,111 shares held directly by Mr. Ehrlich, 166,667 shares of unvested restricted stock (the vesting of 66,667 of which is subject to future performance criteria), 328,767 shares held as part of a trust securing the payment of Mr. Ehrlich's severance package pursuant to the terms of our employment agreement with him, 3,571 shares held by Mr. Ehrlich's wife (in which shares Mr. Ehrlich disclaims beneficial ownership), and 11,527 shares held in Mr. Ehrlich's pension plan.
- (5) Consists of 596,507 shares held directly by Mr. Esses, 125,000 shares of unvested restricted stock (the vesting of 50,000 of which is subject to future performance criteria), and 273,973 shares held as part of a trust securing the payment of Mr. Esses's severance package pursuant to the terms of our employment agreement with him.
- (6) Consists of 253,596 shares held directly by Mr. Paup and 40,000 unvested restricted stock units (the vesting of which is subject to future performance criteria).
- (7) Consists of 39,047 shares owned directly by Dr. Eastman and 22,146 shares of unvested restricted stock.
- (8) Consists of 40,189 shares owned directly by Mr. Borey and 22,146 shares of unvested restricted stock.

- (9) Consists of 39,047 shares owned directly by Prof. Jones and 22,146 shares of unvested restricted stock.
- (10) Consists of 179,772 shares owned directly by Mr. Sloyer and 22,146 shares of unvested restricted stock.
- (11) Consists of 42,337 shares owned directly by Mr. Marrus and 22,146 shares of unvested restricted stock.
- (12) Consists of 24,356 shares owned directly by Mr. Leibowitz and 22,146 shares of unvested restricted stock.
- (13) Includes 424,543 shares of unvested restricted stock (the vesting of 116,667 of which is subject to future performance criteria), 602,740 shares of restricted stock held as part of trusts securing payment of severance, and 40,000 unvested restricted stock units (the vesting of which is subject to future performance criteria).

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## Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth certain information, as of December 31, 2012, with respect to our 2004, 2007 and 2009 equity compensation plans, as well as any other stock options and warrants previously issued by us (including individual compensation arrangements) as compensation for goods and services:

## EQUITY COMPENSATION PLAN INFORMATION

| Plan Category   | Number of securities to be issued upon exercise of outstanding options, warrants and rights<br>(a) | Weighted-average exercise price of outstanding options, warrants and rights<br>(b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))<br>(c) |
|---|--|--|--|
| Equity compensation plans approved by security holders(1) | 12,228   | \$ 5.46  | 3,665,862  |

(1)For a description of the material features of grants of options and warrants other than options granted under our employee stock option plans, see Note 13.c. of the Notes to the Consolidated Financial Statements.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

## Officer Loans

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 we paid on his behalf by giving us 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 our common stock acquired through the exercise of the options and certain compensation due to Mr. Ehrlich upon termination. As of December 31, 2012, the aggregate amount outstanding pursuant to this promissory note was \$452,995.

On June 10, 2002, Mr. Ehrlich exercised 3,571 stock options. Mr. Ehrlich paid the exercise price of the stock options by giving us 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 our common stock acquired through the exercise of the options. As of December 31, 2012, the aggregate amount outstanding pursuant to this promissory note was \$46,593, which was not repaid and was charged to paid in capital in the fourth quarter. Pursuant to the terms of the note the shares of stock securing the note were returned to us and retired in 2013 when the loan was not repaid.

## Consulting Agreement with Sampen Corporation

We have a consulting agreement with Sampen Corporation that we executed in March 2005, effective as of January 1, 2005. Sampen is a New York corporation owned by members of Steven Esses's immediate family, and Mr. Esses is an employee of both the Company and of Sampen. The term of this consulting agreement as extended was to have expired on December 31, 2012, and is extended automatically for additional terms of two years each unless either Sampen or we terminate the agreement sooner. We had previously given notice to Sampen of our intention to terminate this agreement effective December 31, 2012, but by mutual agreement we withdrew this notice prior to its effectiveness.

Pursuant to the terms of our agreement with Sampen, Sampen provides one of its employees to us for such employee to serve as our President. We pay 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 we actually attain for the year in question are 120% or more of the amount we budgeted at the beginning of the year. We also pay Sampen, to cover the cost of our 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.



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ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

In accordance with the requirements of the Sarbanes-Oxley Act of 2002 and the Audit Committee's charter, all audit and audit-related work and all non-audit work performed by our independent accountants, BDO USA, LLP ("BDO"), is approved in advance by the Audit Committee, including the proposed fees for such work. The Audit Committee is informed of each service actually rendered.

- Ø Audit Fees. Audit fees billed or expected to be billed to us by BDO for the audit of the financial statements included in our Annual Report on Form 10-K, and reviews of the financial statements included in our Quarterly Reports on Form 10-Q, for the years ended December 31, 2012 and 2011 totaled approximately \$313,000 and \$340,000, respectively.
- Ø Audit-Related Fees. BDO billed or expected to bill us \$420,000 and \$172,000 (principally consultation related to mergers and acquisitions) for the fiscal years ended December 31, 2012 and 2011, respectively, for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements.
- Ø Tax Fees. BDO billed or expected to bill us an aggregate of \$51,000 and \$87,000 (including consultation related to mergers and acquisitions) for the fiscal years ended December 31, 2012 and 2011, respectively, for tax services, principally advice regarding the preparation of income tax returns.
- Ø All Other Fees. BDO billed or expected to bill us an aggregate of zero for the fiscal years ended December 31, 2012 and 2011, for permitted non-audit services.

Applicable law and regulations provide an exemption that permits certain services to be provided by our outside auditors even if they are not pre-approved. We have not relied on this exemption at any time since the Sarbanes-Oxley Act was enacted.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

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

- (1) Financial Statements – See Index to Financial Statements on page 31 above and the financial pages following page 55 below.
- (2) Financial Statements Schedules – Schedule II - Valuation and Qualifying Accounts.  
All schedules other than those listed above are omitted because of the absence of conditions under which they are required or because the required information is presented in the financial statements or related notes thereto.
- (3) Exhibits – The following Exhibits are either filed herewith or have previously been filed with the Securities and Exchange Commission and are referred to and incorporated herein by reference to such filings:

Exhibit

| No.        | Description  |
|------------|--|
| (1)3.1     | Amended and Restated Certificate of Incorporation  |
| (3)3.1.1   | Amendment to our Amended and Restated Certificate of Incorporation   |
| (5)3.1.2   | Amendment to our Amended and Restated Certificate of Incorporation   |
| (6)3.1.3   | Amendment to our Amended and Restated Certificate of Incorporation   |
| (8)3.1.4   | Amendment to our Amended and Restated Certificate of Incorporation   |
| (9)3.1.5   | Amendment to our Amended and Restated Certificate of Incorporation   |
| (2)3.2     | Amended and Restated By-Laws   |
| (7)4.1     | Specimen Certificate for shares of common stock, \$0.01 par value  |
| (7)10.1    | Promissory Note dated February 9, 2000, from Robert S. Ehrlich to us   |
| (4)10.2    | Promissory Note dated July 1, 2002 from Robert S. Ehrlich to us  |
| (4)10.3    | Lease dated April 8, 1997, between AMR Holdings, L.L.C. and FAAC Incorporated  |
| † (6)10.4  | Consulting Agreement, effective as of January 1, 2005, between us and Sampen Corporation   |
| (7)10.5    | Lease dated February 10, 2006 between Arbor Development Company LLC and FAAC Incorporated  |
| † (10)10.6 | Fifth Amended and Restated Employment Agreement, dated February 2, 2012 and effective as of January 1, 2012, between us, EFL and Robert S. Ehrlich           |
| † (10)10.7 | Second Amended and Restated Employment Agreement, dated February 2, 2012 and effective as of January 1, 2012, between EFL and Steven Esses                   |
| † (10)10.8 | Second Amended and Restated Employment Agreement between the Company and Thomas J. Paup dated February 2, 2012 and effective as of January 1, 2012           |
| *10.9      | Credit Agreement among FAAC Incorporated, the Company and Fifth Third Bank dated April 30, 2012  |
| *10.10     | Security Agreement between FAAC Incorporated and Fifth Third Bank dated April 30, 2012   |
| *10.11     | Guaranty of the Company and Electric Fuel Battery Corporation to Fifth Third Bank dated April 30, 2012   |
| (11)21.1   | List of Subsidiaries of the Registrant   |
| *23.1      | <u>Consent of BDO USA, LLP</u>   |
| *31.1      | <u>Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>  |
| *31.2      | <u>Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>  |
| *32.1      | <u>Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| *32.2      |  |

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

101.INS XBRL Instance Document  
101.SCH XBRL Taxonomy Extension Schema Document  
101.CAL XBRL Taxonomy Extension Calculation Linkbase Document  
101.DEF XBRL Taxonomy Extension Definition Linkbase Document  
101.LAB XBRL Taxonomy Extension Label Linkbase Document  
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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\*Filed herewith

†Includes management contracts and compensation plans and arrangements

- (1) Incorporated by reference to our Registration Statement on Form S-1 (Registration No. 33-73256), which became effective on February 23, 1994
- (2) Incorporated by reference to our Registration Statement on Form S-1 (Registration No. 33-97944), which became effective on February 5, 1996
- (3) Incorporated by reference to our Current Report on Form 8-K filed January 6, 2003
- (4) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2003
- (5) Incorporated by reference to our Current Report on Form 8-K filed July 15, 2004
- (6) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2004
- (7) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2005
- (8) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006
- (9) Incorporated by reference to our Current Report on Form 8-K filed January 3, 2008
- (10) Incorporated by reference to our Current Report on Form 8-K filed June 9, 2009
- (11) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2011

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SIGNATURES

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

AROTECH CORPORATION

|                     |     |   |
|---------------------|-----|---|
| Date: April 1, 2013 | By: | /s/ Robert S. Ehrlich<br>Name: Robert S. Ehrlich<br>Title: Chairman and Chief Executive Officer |
|---------------------|-----|---|

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

| Signature                                      | Title  | Date          |
|--|--|---------------|
| /s/ Robert S. Ehrlich<br>Robert S. Ehrlich     | Chairman Chief Executive Officer and Director<br>(Principal Executive Officer) | April 1, 2013 |
| /s/ Thomas J. Paup<br>Thomas J. Paup           | Vice President – Finance<br>(Principal Financial Officer)                      | April 1, 2013 |
| /s/ Norman E. Johnson<br>Norman E. Johnson     | Controller<br>(Principal Accounting Officer)                                   | April 1, 2013 |
| /s/ Steven Esses<br>Steven Esses               | President and Director   | April 1, 2013 |
| /s/ Jay M. Eastman<br>Dr. Jay M. Eastman       | Director   | April 1, 2013 |
| /s/ Edward J. Borey<br>Edward J. Borey         | Director   | April 1, 2013 |
| /s/ Seymour Jones<br>Seymour Jones             | Director   | April 1, 2013 |
| /s/ Elliot Sloyer<br>Elliot Sloyer             | Director   | April 1, 2013 |
| /s/ Michael E. Marrus<br>Michael E. Marrus     | Director   | April 1, 2013 |
| /s/ Arthur S. Leibowitz<br>Arthur S. Leibowitz | Director   | April 1, 2013 |



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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 and subsidiaries (the “Company”) as of December 31, 2012 and 2011 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 schedule. 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, 2012 and 2011, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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.

/s/ BDO USA, LLP

Grand Rapids, Michigan

April 1, 2013

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**AROTECH CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**


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In U.S. dollars

|  | December 31,  |               |
|--|---------------|---------------|
|  | 2012          | 2011          |
| <b>ASSETS</b>                                  |               |               |
| <b>CURRENT ASSETS:</b>                         |               |               |
| Cash and cash equivalents                      | \$ 1,580,627  | \$ 2,324,163  |
| Restricted collateral deposits                 | 186,306       | 1,679,609     |
| Trade receivables                              | 9,639,709     | 11,883,779    |
| Unbilled receivables                           | 13,374,004    | 5,722,781     |
| Other accounts receivable and prepaid expenses | 1,178,780     | 1,453,152     |
| Inventories                                    | 10,033,525    | 9,503,171     |
| Discontinued operations – short term           | 389,272       | 6,032,625     |
| Total current assets                           | 36,382,223    | 38,599,280    |
| <b>LONG TERM ASSETS:</b>                       |               |               |
| Severance pay fund                             | 4,177,488     | 3,554,877     |
| Other long term receivables                    | 55,156        | 58,596        |
| Property and equipment, net                    | 4,464,580     | 4,631,007     |
| Other intangible assets, net                   | 2,238,273     | 3,153,104     |
| Goodwill                                       | 30,562,298    | 30,421,198    |
| Discontinued operations – long term            | –             | 683,883       |
| Total long term assets                         | 41,497,795    | 42,502,665    |
| Total assets                                   | \$ 77,880,018 | \$ 81,101,945 |

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



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**AROTECH CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

In U.S. dollars

|  | December 31,  |               |
|--|---------------|---------------|
|  | 2012          | 2011          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                      |               |               |
| <b>CURRENT LIABILITIES:</b>  |               |               |
| Trade payables   | \$7,156,327   | \$6,694,127   |
| Other accounts payable and accrued expenses                                      | 4,252,910     | 3,634,133     |
| Current portion of capitalized leases  | –             | 11,053        |
| Current portion of long term debt  | 888,839       | 94,595        |
| Short term bank credit   | 9,787,779     | 6,618,431     |
| Deferred revenues  | 3,798,086     | 4,019,425     |
| Discontinued operations – short term   | 588,592       | 7,306,967     |
| Total current liabilities  | 26,472,533    | 28,378,731    |
| <b>LONG TERM LIABILITIES:</b>  |               |               |
| Accrued severance pay  | 6,133,042     | 5,268,827     |
| Long term portion of capitalized leases  | –             | 495           |
| Long term portion of debt  | 992,917       | 1,018,750     |
| Deferred tax liability   | 4,920,021     | 4,321,521     |
| Other long term liabilities  | 27,590        | 24,345        |
| Discontinued operations – long term  | 912,813       | 963,814       |
| Total long-term liabilities  | 12,986,383    | 11,597,752    |
| <b>STOCKHOLDERS' EQUITY:</b>   |               |               |
| Share capital –  |               |               |
| Common stock – \$0.01 par value each;  |               |               |
| Authorized: 50,000,000 shares as of December 31, 2012 and 2011; Issued and       |               |               |
| outstanding: 16,151,298 shares and 15,570,491 shares as of December 31, 2012 and |               |               |
| 2011, respectively   |               |               |
|  | 161,513       | 155,705       |
| Preferred shares – \$0.01 par value each;  |               |               |
| Authorized: 1,000,000 shares as of December 31, 2012 and 2011; No shares issued  |               |               |
| or outstanding as of December 31, 2012 and 2011                                  |               |               |
|  | –             | –             |
| Additional paid-in capital   | 223,181,705   | 222,786,426   |
| Accumulated deficit  | (185,248,923) | (182,232,246) |
| Notes receivable from stockholders   | (908,054)     | (954,647)     |
| Accumulated other comprehensive income   | 1,234,861     | 1,370,224     |
| Total stockholders' equity   | 38,421,102    | 41,125,462    |
| Total liabilities and stockholders' equity                                       | \$77,880,018  | \$81,101,945  |

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

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AROTECH CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

In U.S. dollars

|  | December 31,   |                 |
|--|----------------|-----------------|
|  | 2012           | 2011            |
| Revenues   | \$80,050,434   | \$62,135,578    |
| Cost of revenues   | 62,141,038     | 45,950,930      |
| Research and development expenses  | 2,043,718      | 1,401,868       |
| Selling and marketing expenses   | 5,487,910      | 5,254,891       |
| General and administrative expenses  | 10,052,765     | 10,677,855      |
| Amortization of intangible assets  | 1,185,539      | 1,905,097       |
| Total operating costs and expenses   | 80,910,970     | 65,190,641      |
| Operating loss   | (860,536 )     | (3,055,063 )    |
| Other income   | (8,284 )       | (43,852 )       |
| Allowance for legal settlements, net   | —              | 12,333          |
| Financial expense, net   | 547,986        | 331,006         |
| Total other expense  | 539,702        | 299,487         |
| Loss from continuing operations before income tax expense                                | (1,400,238 )   | (3,354,550 )    |
| Income tax expense   | 628,156        | 1,608,611       |
| Loss from continuing operations  | (2,028,394 )   | (4,963,161 )    |
| Loss from discontinued operations, net of income tax                                     | (988,283 )     | (6,563,844 )    |
| Net loss   | (3,016,677 )   | (11,527,005 )   |
| Other comprehensive income, net of income tax - \$0 for both years                       |                |                 |
| Foreign currency translation adjustment  | (135,363 )     | (769,515 )      |
| Comprehensive loss   | \$(3,152,040 ) | \$(12,296,520 ) |
| Basic and diluted net loss per share – continuing operations                             | \$(0.14 )      | \$(0.35 )       |
| Basic and diluted net loss per share – discontinued operations                           | \$(0.07 )      | \$(0.47 )       |
| Basic and diluted net loss per share   | \$(0.21 )      | \$(0.82 )       |
| Weighted average number of shares used in computing basic and diluted net loss per share | 14,713,583     | 14,011,566      |

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

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AROTECH CORPORATION AND SUBSIDIARIES  
 STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

|  | Common stock |            | Additional<br>paid-in | Accumulated      | Notes<br>receivable<br>from | Accumulated<br>other<br>comprehensive<br>income | Total<br>stockholders' |
|--|--------------|------------|-----------------------|------------------|-----------------------------|---|------------------------|
|  | Shares       | Amount     | capital               | deficit          | stockholders                | (loss)  | equity                 |
| Balance as of<br>January 1,<br>2011              | 14,842,283   | \$ 148,423 | \$ 221,856,095        | \$ (170,705,241) | \$ (954,647)                | \$ 2,139,739                                    | \$ 52,484,369          |
| Treasury stock<br>purchase and<br>retirement     | (75,402)     | (754)      | (112,544)             | —                | —                           | —   | (113,298)              |
| Conversion of<br>convertible<br>notes            | 324,326      | 3,243      | 639,176               | —                | —                           | —   | 642,419                |
| Stock based<br>compensation                      | —            | —          | 408,492               | —                | —                           | —   | 408,492                |
| Restricted<br>stock issued                       | 414,284      | 4,143      | (4,143)               | —                | —                           | —   | —                      |
| Restricted<br>stock units<br>vested              | 65,000       | 650        | (650)                 | —                | —                           | —   | —                      |
| Foreign<br>currency<br>translation<br>adjustment | —            | —          | —                     | —                | —                           | (769,515)                                       | (769,515)              |
| Net loss   | —            | —          | —                     | (11,527,005)     | —                           | —   | (11,527,005)           |
| Balance as of<br>December 31,<br>2011            | 15,570,491   | \$ 155,705 | \$ 222,786,426        | \$ (182,232,246) | \$ (954,647)                | \$ 1,370,224                                    | \$ 41,125,462          |

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

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## AROTECH CORPORATION AND SUBSIDIARIES

## STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (continued)

In U.S. dollars

|  | Common stock |            | Additional<br>paid-in | Accumulated      | Notes<br>receivable<br>from | Accumulated<br>other<br>comprehensive<br>income | Total<br>stockholders'<br>equity |
|--|--------------|------------|-----------------------|------------------|-----------------------------|---|----------------------------------|
|  | Shares       | Amount     | capital               | deficit          | stockholders                | (loss)  |                                  |
| Balance as of<br>January 1,<br>2012              | 15,570,491   | \$ 155,705 | \$ 222,786,426        | \$ (182,232,246) | \$ (954,647)                | \$ 1,370,224                                    | \$ 41,125,462                    |
| Stock based<br>compensation                      | —            | —          | 447,680               | —                | —                           | —   | 447,680                          |
| Restricted<br>stock issued                       | 517,582      | 5,176      | (5,176)               | —                | —                           | —   | —                                |
| Restricted<br>stock units<br>vested              | 63,225       | 632        | (632)                 | —                | —                           | —   | —                                |
| Write-down of<br>shareholder<br>loans            | —            | —          | (46,593)              | —                | 46,593                      | —   | —                                |
| Foreign<br>currency<br>translation<br>adjustment | —            | —          | —                     | —                | —                           | (135,363)                                       | (135,363)                        |
| Net loss   | —            | —          | —                     | (3,016,677)      | —                           | —   | (3,016,677)                      |
| Balance as of<br>December 31,<br>2012            | 16,151,298   | \$ 161,513 | \$ 223,181,705        | \$ (185,248,923) | \$ (908,054)                | \$ 1,234,861                                    | \$ 38,421,102                    |

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

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**AROTECH CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

In U.S. dollars

|  | 2012           | 2011            |
|--|----------------|-----------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                |                 |
| Net loss   | \$(3,016,677 ) | \$(11,527,005 ) |
| Adjustments required to reconcile net loss to net cash provided by (used in) operating activities: |                |                 |
| Depreciation   | 1,087,178      | 1,103,943       |
| Amortization of intangible assets  | 1,185,539      | 1,905,097       |
| Amortization of debt discount  | —              | 39,351          |
| Stock based compensation   | 447,680        | 408,492         |
| Adjustment to value of warrants and embedded features on the senior convertible notes              | —              | (161,339 )      |
| Capital (gain) loss from sale of property and equipment  | 15,668         | (150 )          |
| Deferred tax provision   | 598,500        | 1,658,813       |
| Changes in continuing operating assets and liabilities:  |                |                 |
| Severance pay, net   | 241,604        | 186,238         |
| Trade receivables  | 2,244,070      | 186,547         |
| Other accounts receivable and prepaid expenses   | 277,812        | (416,270 )      |
| Inventories  | (530,354 )     | (1,735,022 )    |
| Unbilled receivables   | (7,651,223 )   | (2,441,960 )    |
| Deferred revenues  | (221,339 )     | (1,749,100 )    |
| Trade payables   | 462,200        | 3,437,054       |
| Other accounts payable and accrued expenses  | 622,022        | (2,026,504 )    |
| Discontinued operations, including impairment of goodwill and other long-lived assets              | (165,884 )     | 5,315,233       |
| Net cash provided by (used in) operating activities  | (4,403,204 )   | (5,816,582 )    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                |                 |
| Purchase of property and equipment   | (950,132 )     | (2,633,562 )    |
| Additions to capitalized software development  | (334,700 )     | (406,118 )      |
| Proceeds from sale of property and equipment   | 13,713         | 12,354          |
| Sales of available for sale securities   | —              | 399,449         |
| Decrease (increase) in restricted collateral deposits  | 1,493,303      | (6,820 )        |
| Discontinued operations  | 148,661        | (114,674 )      |
| Net cash provided by (used in) investing activities  | \$370,845      | \$(2,749,371 )  |

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

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AROTECH CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

In U.S. dollars

|  | 2012               | 2011                |
|--|--------------------|---------------------|
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                   |                    |                     |
| Proceeds from (repayment of) long term debt                                    | \$756,863          | \$(816,415 )        |
| Change in short term bank credit   | 3,169,348          | 4,130,226           |
| Purchase of treasury stock   | —                  | (113,298 )          |
| Additions to long term debt  | —                  | 1,125,000           |
| Discontinued operations  | (393,314 )         | 293,509             |
| Net cash provided by (used in) financing activities                            | 3,532,897          | 4,619,022           |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                        | <b>(499,462 )</b>  | <b>(3,946,931 )</b> |
| <b>CASH DIFFERENCES DUE TO EXCHANGE RATE CHANGES</b>                           | <b>(212,471 )</b>  | <b>(97,961 )</b>    |
| <b>CASH DIFFERENCES DUE TO EXCHANGE RATE CHANGES – DISCONTINUED OPERATIONS</b> | <b>—</b>           | <b>108,689</b>      |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS - DISCONTINUED</b>                  | <b>(31,603 )</b>   | <b>459,881</b>      |
| <b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR</b>                  | <b>2,324,163</b>   | <b>5,800,485</b>    |
| <b>CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR</b>                        | <b>\$1,580,627</b> | <b>\$2,324,163</b>  |
| <b>SUPPLEMENTARY INFORMATION ON NON-CASH AND OTHER TRANSACTIONS:</b>           |                    |                     |
| Interest paid during the year  | \$400,905          | \$160,215           |
| Taxes on income paid during the year   | \$38,118           | \$160,847           |
| Note conversion to common stock  | \$—                | \$642,419           |

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

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

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, and multimedia interactive simulators/trainers. The Company operates primarily through its wholly-owned subsidiaries FAAC Incorporated (“FAAC”), based in Ann Arbor, Michigan with locations in Royal Oak, Michigan and Orlando, Florida; Electric Fuel Battery Corporation (“EFB”), based in Auburn, Alabama; and Epsilor-Electric Fuel Ltd. (“Epsilor-EFL”), based in Dimona, Israel with a location in Beit Shemesh, Israel. EFB and Epsilor-EFL form the Company’s Battery and Power Systems Division. IES Interactive Training (“IES”) and Realtime Technologies (“RTI”) were merged with FAAC in 2007 and 2010, respectively, to create Arotech’s Training and Simulation Division. Pursuant to a management decision in the fourth quarter of 2011 and sale in 2012, the Company’s Armor Division, consisting of M.D.T. Protective Industries, Ltd. (“MDT”), based in Lod, Israel, and MDT Armor Corporation (“MDT Armor”), based in Auburn, Alabama, along with the trade name of Armour of America Incorporated (“AoA”), are reflected as discontinued operations for all periods presented.

b. Impairment of goodwill and other long-lived assets:

Goodwill and indefinite-lived intangible assets are tested for impairment at least annually and between annual tests in certain circumstances, and written down when impaired. Goodwill is tested for impairment by comparing the fair value of the Company’s reporting units with their carrying value. All of the Company’s continuing reporting units have goodwill. 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 September 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-08, “Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment.” ASU 2011-08 amends the guidance in Accounting Standards Codification (“ASC”) 350, Intangibles – Goodwill and Other. Under the revised guidance, when testing goodwill for impairment, the Company has the option of performing a qualitative assessment in order to determine whether it needs to calculate the fair value of a reporting unit. If the Company determines, on the basis of qualitative factors, that it is more likely than not that the fair value of the reporting unit is greater than the carrying amount, the two-step impairment test would not be required. The Company early adopted the ASU in 2011.

In both 2012 and 2011, the Company determined, using qualitative factors, that the goodwill for the Training and Simulation reporting unit was not impaired. In both 2012 and 2011, the Company completed the first step of the quantitative analysis of the goodwill in the Battery and Power Systems reporting unit, in which it computed a fair value of that reporting unit. Because the fair value was greater than the carrying value of the unit at the measurement date, the second step of the quantitative impairment assessment was not required and no goodwill was impaired. Although the valuation for Battery and Power Systems Division exceeded the reporting unit’s carrying value by 14%, the Company will continue to monitor the actual results of the reporting unit versus the forecast used for the impairment review and reevaluate the goodwill as required. Additionally, the Company performed a complete long-lived asset impairment review of the discontinued Armor reporting unit in 2011 that resulted in the full impairment of that unit’s goodwill (\$1,792,339) and property and equipment (\$1,487,219), as reported in discontinued

operating results.

Although the cumulative carrying value of the Company's reporting units exceeded the Company's market value as determined by its stock price as of the impairment review, management nevertheless determined that the fair value of the Training and Simulation and Battery and Power Systems reporting units exceeded their respective carrying values, and therefore, there would be no impairment charges relating to goodwill for these reporting units. 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, including unallocated corporate costs;
- 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 and thereby serves to understate their value; and
  - Control premiums reflected in the reporting unit fair values but not in the Company's stock price.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 1:— GENERAL (Cont.)

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.

c. 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 an additional term of two years until December 31, 2014, unless either Sampen or the Company terminates the agreement sooner.

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 President. 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, 2012 and 2011, the Company incurred a total of \$185,856 each year related to Sampen.

On February 9, 2000, Mr. Ehrlich, the Company's Chief Executive Officer, 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, 2012 and 2011, the aggregate amount outstanding pursuant to this promissory note was \$452,995. Additionally, 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, 2012, the aggregate amount outstanding pursuant to this promissory note was \$46,593, which was not repaid and was charged to paid in capital in the fourth quarter of 2012. Pursuant to the terms of the note, the shares of stock securing the note were returned to the Company and retired in 2013 when the loan was not repaid.

d. Discontinued operations

In December 2011, the Company's Board of Directors approved management's plan to sell the Armor Division. On March 8, 2012, the Company signed a non-binding letter of intent to sell the division to an Israeli public company. The sale of the assets was completed in June 2012 at a cash purchase price of \$50,000. Unless otherwise indicated, discontinued operations are not included in the Company's reported results.

Unless otherwise noted, amounts and disclosures throughout the Notes to Consolidated Financial Statements relate to the Company's continuing operations. The assets and liabilities of the discontinued operation after impairment, the revenues and expenses of the discontinued operation and a list of unusual expenses relating to the discontinued operation are shown below.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

## NOTE 1:— GENERAL (Cont.)

## ASSETS AND LIABILITIES – DISCONTINUED

|   | December 31, |              |
|---|--------------|--------------|
|   | 2012         | 2011         |
| <b>ASSETS</b>   |              |              |
| <b>CURRENT ASSETS:</b>                                |              |              |
| Cash and cash equivalents                             | \$ 106,548   | \$ 74,945    |
| Restricted collateral deposits                        | 44,827       | 193,488      |
| Trade receivables                                     | 164,824      | 2,131,599    |
| Other accounts receivable and prepaid expenses        | 73,073       | 133,149      |
| Inventories   | —            | 3,499,444    |
| Total current assets                                  | 389,272      | 6,032,625    |
| <b>LONG TERM ASSETS:</b>                              |              |              |
| Severance pay fund                                    | —            | 683,883      |
| Total long term assets                                | —            | 683,883      |
| Total assets  | \$ 389,272   | \$ 6,716,508 |
| <b>LIABILITIES</b>                                    |              |              |
| <b>CURRENT LIABILITIES:</b>                           |              |              |
| Trade payables  | \$ 75,862    | \$ 4,165,367 |
| Other accounts payable and accrued expenses           | 453,443      | 2,250,584    |
| Current portion of long term debt (building mortgage) | 59,287       | 401,600      |
| Deferred revenues                                     | —            | 489,416      |
| Total current liabilities                             | 588,592      | 7,306,967    |
| <b>LONG TERM LIABILITIES</b>                          |              |              |
| Long term debt (building mortgage)                    | 912,813      | 963,814      |
| Total long-term liabilities                           | 912,813      | 963,814      |
| Total liabilities                                     | \$ 1,501,405 | \$ 8,270,781 |

## REVENUE AND EXPENSES – DISCONTINUED

|                                     | December 31, |               |
|-------------------------------------|--------------|---------------|
|                                     | 2012         | 2011          |
| Revenues                            | \$ 6,890,664 | \$ 17,411,879 |
| Cost of revenues                    | 6,476,082    | 15,924,925    |
| Research and development expenses   | —            | 643,201       |
| Selling and marketing expenses      | 301,990      | 835,957       |
| General and administrative expenses | 493,868      | 2,504,746     |
| Impairment of long lived assets     | —            | 3,279,558     |
| Amortization of intangible assets   | —            | 13,350        |
| Total operating costs and expenses  | 7,271,940    | 23,201,737    |
| Operating loss                      | (381,276)    | (5,789,858)   |
| Other (income) expense              | (288,594)    | 20,909        |
| Financial expense, net              | 66,111       | 483,624       |

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|                                       |              |                |
|---------------------------------------|--------------|----------------|
| Loss from affiliated company          | –            | 269,453        |
| Total other expense                   | (222,483)    | 773,986        |
| Loss before income tax benefit        | (158,793)    | (6,563,844)    |
| Income tax benefit                    | –            | –              |
| Net loss                              | \$ (158,793) | \$ (6,563,844) |
| Loss on sale, net of \$0 income taxes | \$ (829,490) | \$ –           |

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AROTECH CORPORATION AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 1:— GENERAL (Cont.)

|  | Year Ended<br>December 31,<br>2011 |
|--|------------------------------------|
| Non-recurring charges related to discontinued operations |                                    |
| Impairment of goodwill and intangibles                   | \$ 1,792,339                       |
| Impairment of property and equipment, net                | 1,487,219                          |
| Write off of affiliated company loan and investment      | 269,453                            |
| Adjustments to severance - Israel                        | 301,876                            |
| Total  | \$ 3,850,887                       |

The Company retained the facility used by the Armor operations and currently leases it to the buyer of those operations under a three year operating lease for \$9,300 per month. The Company is marketing the facility for sale (it is included within Discontinued Operations), and it has no recorded book value as of December 31, 2012. The Company remains responsible for the outstanding mortgage on this facility, which was \$950,000 as of December 31, 2012 (as further described in Note 11), and which it expects to either transfer with the sale of the facility or pay off with the related sales proceeds plus other available cash resources as necessary

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 are generated in U.S. dollars (“dollars”). In addition, a substantial portion of the Company’s costs are incurred in dollars. 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 dollars are remeasured into dollars, with resulting gains and losses reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

The majority of transactions of MDT (discontinued) and Epsilor-EFL are in New Israel Shekels (“NIS”) and a substantial portion of MDT’s and Epsilor-EFL’s costs is incurred in NIS. Management believes that the NIS is the functional currency of MDT and Epsilor-EFL. Accordingly, the financial statements of MDT and Epsilor-EFL have been translated into 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 (loss) in stockholders' equity. All accumulated other comprehensive income related to the Armor Division, in the amount of \$189,969, was recorded as an adjustment to the loss on sale in discontinued operations. As of December 31, 2012, all accumulated other comprehensive income represents foreign currency translation adjustments.

c. Principles of consolidation:

The consolidated financial statements include the accounts of Arotech 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.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Restricted collateral deposits:

Restricted collateral deposits are primarily invested in highly liquid deposits which are used as a security for the Company's performance guarantees at FAAC and Epsilor-EFL.

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 securities 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. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of operations. The Company did not hold any marketable securities at either December 21, 2012 or 2011.

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 2012 and 2011, the Company wrote off \$57,000 and \$145,000, 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 costs.

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 Law for the Encouragement of Capital Investments, 5719-1959 (the "Investments Law"). The Company did not receive any investment grants in 2012 and 2011.

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

Depreciable life (in  
years)

|  |   |
|--|---|
| Computers and related equipment        | 3 to 5  |
| Motor vehicles                         | 5 to 7  |
| Office furniture and equipment         | 10  |
| Machinery, equipment and installations | 10  |
| Buildings                              | 30  |
| Land                                   | Not depreciated   |
| Leasehold improvements                 | Shorter of the term of the lease or the life of the asset |
| Demo inventory                         | 5   |



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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

i. Revenue recognition:

The Company is a defense and security products and services company, engaged in two business areas: interactive simulation for military, law enforcement and commercial markets; and batteries and charging systems for the military. During 2012 and 2011, the Company recognized revenues (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 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 (iii) from the sale of lifejacket lights (Battery and Power Systems Division).

Revenues from products sold by the Battery and Power Systems 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. Typically revenue is recognized, per the contract, when the transaction is entered into the U.S. Government's Wide Area Workflow system, which occurs after the products have been accepted at the plant or when shipped. Sales to other entities are recorded in accordance with the contract, either when shipped or delivered. Normally, in this division, there are no further obligations that would preclude the recognition of revenue.

Revenues from contracts in the Training and Simulation Division that involve customization of the system to customer 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. Normally there are no further obligations that would preclude the recognition of revenue.

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, customer prepayments and billing in excess of costs and estimated earnings on uncompleted contracts.

j.           Warranty:

The Company typically offers a one to two 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 costs 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. (See Note 17.)

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. 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 (one to three 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, 2012.

In 2012 and 2011, the Training and Simulation Division capitalized approximately \$335,000 and \$406,000, respectively, in software development costs that will be amortized on a straight-line method over 2 years, the useful life of the software.

l. Income taxes:

The Company accounts for income taxes under the asset and liability method, whereby deferred tax assets and liability account balances are determined based on tax credit carryforwards and differences between the 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.

The Company has 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. The Company 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 the Company's determinations and estimates prove to be inaccurate, the resulting adjustments could be material to the Company's future financial statements.

m. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, restricted collateral deposits and trade receivables. 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.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

n. 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 614,968 and 701,411 for the years ended December 31, 2012 and 2011, respectively.

o. Accounting for stock-based compensation:

Stock-based awards to employees are recognized as compensation expense based on the calculated fair value on the date of grant. The Company determines the fair value of options 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 2012 or 2011. The Company assumed a 20% forfeiture rate on existing options for both years. The Company typically uses a 5-10% forfeiture rate for restricted stock and restricted stock units and adjusts both forfeiture rates based on historical forfeitures. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock.

p. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating their fair value disclosures for financial instruments using the required three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which may require the Company to develop its own assumptions.

The carrying amounts of cash and cash equivalents, restricted collateral deposits, 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 securities was based on the quoted market price.

The fair values of 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 (Level 3).

q. 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 held by insurance companies on behalf of the employees, insurance policies and by accrual. The fair value of these funds, which are considered Level 2 fair value measurements, is recorded as an asset in the Company's balance sheet.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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. As of December 31, 2012, the Company had made a provision of \$217,733 for this special severance pay. As of December 31, 2012 and 2011, the unfunded severance pay in that regard amounted to \$1,267,844 and \$1,050,111, respectively.

Pursuant to the terms of the respective employment agreements between the Company and its Chief Executive Officer and its President, funds to secure payment of their respective contractual 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 and losses 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 fair 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 President, 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 to 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 their 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 continuing operations for the years ended December 31, 2012 and 2011 amounted to \$19,216 and \$249,010, respectively.

r. Advertising costs:

The Company records advertising costs as incurred. Advertising expense for the years ended December 31, 2012 and 2011 was approximately \$155,887 and \$166,701, respectively.

s. New accounting pronouncements:

Effective January 1, 2011, the Company adopted ASU 2009-13, "Revenue Recognition (Accounting Standards Codification 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) 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 are required to estimate the selling prices of those elements. Overall arrangement consideration

is 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. Additionally, ASU 2009-14 provides guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software that is not essential to the product's functionality. ASU 2009-14 requires the same expanded disclosures that are included within ASU 2009-13. The impact of adoption did not have a significant impact on the Company's consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 2:— SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In June 2011, the FASB issued ASU No. 2011-05, “Comprehensive Income (Topic 220) — Presentation of Comprehensive Income.” ASU 2011-05 eliminates the current option to report other comprehensive income and its components in the statement of changes in stockholders’ equity and requires that all non-owner changes in stockholders’ equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The Company adopted the disclosure standard in January 2012.

In July 2012, the FASB issued ASU 2012-02 “Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment” (“ASU 2012-02”). ASU 2012-02 permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test. Under the amendments in ASU 2012-02, an entity is not required to calculate the fair value of an indefinite-lived intangible asset unless it determines that it is more likely than not that the fair value of the asset is less than its carrying amount. An entity also will have the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. ASU 2012-02 is effective for interim and annual indefinite-lived intangible asset impairment tests performed for fiscal years beginning on or after September 15, 2012, with early adoption permitted. The Company’s adoption of ASU 2012-02 is not expected to have a material impact on its consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This ASU is intended to improve the reporting of reclassifications out of accumulated other comprehensive income. The ASU requires an entity to report, either on the face of the statement where net income is presented or in the notes to the financial statements, the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in their entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in this ASU apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP and that report items of other comprehensive income. For public entities, the amendments in this ASU are effective prospectively for reporting periods beginning after December 15, 2012. The impact of adoption of this ASU by the Company is not expected to be material.

No other new accounting pronouncements issued or effective during 2012 have had or are expected to have a significant impact on the Company’s consolidated financial statements.

t. Share repurchase:

In February 2009, the Company’s Board of Directors authorized the repurchase in the open market or in privately negotiated transactions of up to \$1,000,000 of the Company’s common stock. Through December 31, 2012, the Company repurchased 638,611 shares for a total of \$869,931. The repurchase program, which expires on August 13, 2013, is subject to management’s discretion.

u. Reclassification:

Prior period amounts are reclassified, when necessary, to conform to the current period presentation.

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In U.S. dollars

NOTE 3:— RESTRICTED COLLATERAL DEPOSITS

The following is a summary of restricted collateral deposits as of December 31, 2012 and 2011:

|  | 2012       | December 31,<br>2011 |
|--|------------|----------------------|
| Deposits in connection with Epsilor projects | \$ 40,164  | \$ 39,239            |
| Deposits in connection with FAAC projects    | 146,142    | 1,640,370            |
| Total restricted collateral deposits         | \$ 186,306 | \$ 1,679,609         |

NOTE 4:— OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

The following is a summary of other accounts receivable and prepaid expenses as of December 31, 2012 and 2011:

|                        | 2012         | December 31,<br>2011 |
|------------------------|--------------|----------------------|
| Government authorities | \$ 101,509   | \$ 405,961           |
| Employees              | 184,423      | 131,764              |
| Prepaid expenses       | 552,568      | 746,331              |
| Other                  | 340,280      | 169,096              |
| Total                  | \$ 1,178,780 | \$ 1,453,152         |

NOTE 5:— INVENTORIES

|                             | 2012          | December 31,<br>2011 |
|-----------------------------|---------------|----------------------|
| Raw and packaging materials | \$ 7,455,426  | \$ 7,688,821         |
| Work in progress            | 363,415       | 1,025,030            |
| Finished products           | 2,214,684     | 789,320              |
| Total                       | \$ 10,033,525 | \$ 9,503,171         |

NOTE 6:— PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

|                                 | 2012         | December 31,<br>2011 |
|---------------------------------|--------------|----------------------|
| Cost:                           |              |                      |
| Computers and related equipment | \$ 2,290,850 | \$ 2,247,918         |
| Motor vehicles                  | 492,584      | 443,483              |

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|  |               |               |
|--|---------------|---------------|
| Office furniture and equipment         | 1,068,526     | 1,229,241     |
| Machinery, equipment and installations | 5,755,750     | 5,193,498     |
| Buildings                              | 1,376,036     | 1,350,820     |
| Land                                   | 300,000       | 300,000       |
| Leasehold improvements                 | 1,107,649     | 1,030,546     |
| Demo inventory                         | 1,617,416     | 1,605,494     |
|  | \$ 14,008,811 | \$ 13,401,000 |

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In U.S. dollars

NOTE 6:– PROPERTY AND EQUIPMENT, NET (Cont.)

|  | December 31, |              |
|--|--------------|--------------|
|  | 2012         | 2011         |
| Accumulated depreciation:              |              |              |
| Computers and related equipment        | \$ 2,102,237 | \$ 2,015,704 |
| Motor vehicles                         | 186,224      | 119,699      |
| Office furniture and equipment         | 956,471      | 1,030,360    |
| Machinery, equipment and installations | 4,119,078    | 3,645,155    |
| Buildings                              | 82,103       | 20,257       |
| Leasehold improvements                 | 828,920      | 761,429      |
| Demo inventory                         | 1,269,198    | 1,177,389    |
|  | 9,544,231    | 8,769,993    |
| Property and equipment, net            | \$ 4,464,580 | \$ 4,631,007 |

- b. Depreciation expense amounted to \$1,087,178 and \$1,103,943 for the years ended December 31, 2012 and 2011, respectively.

As for liens, see Note 10.d.

NOTE 7:– GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

The Company allocates goodwill acquired in a business combination to the appropriate reporting unit as of the acquisition date. Currently, the Company's reporting units are also its reportable segments and the associated goodwill was determined when the specific businesses in the reportable segments were purchased.

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

|                                    | December 31,<br>2011 | Additions | Adjustments<br>(currency) | December 31,<br>2012 |
|------------------------------------|----------------------|-----------|---------------------------|----------------------|
| Training and Simulation Division   | \$24,435,641         | \$–       | \$–                       | \$24,435,641         |
| Battery and Power Systems Division | 5,985,557            | –         | 141,100                   | 6,126,657            |
| Total                              | \$30,421,198         | \$–       | \$141,100                 | \$30,562,298         |

b. Other intangible assets:

|                            |                | December 31, |                |              |                |
|----------------------------|----------------|--------------|----------------|--------------|----------------|
|                            |                | 2012         |                | 2011         |                |
|                            | Useful<br>life | Cost         | Net book value | Cost         | Net book value |
| Technology                 | 4-8 years      | \$ 6,788,000 | \$ 189,429     | \$ 6,788,000 | \$ 284,143     |
| Capitalized software costs | 1-3 years      | 3,690,416    | 491,433        | 3,355,716    | 616,819        |
| Trademarks                 | 10 years       | 28,000       | 14,000         | 28,000       | 16,800         |

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|                                 |            |               |              |               |              |
|---------------------------------|------------|---------------|--------------|---------------|--------------|
| Backlog/customer relationship   | 1-10 years | 744,000       | 31,000       | 744,000       | 37,200       |
| Customer list                   | 2-10 years | 6,773,645     | 621,740      | 6,773,645     | 1,243,480    |
|                                 |            | 18,024,061    | \$ 1,347,602 | 17,689,361    | \$ 2,198,442 |
| Exchange rate differences       |            | 91,671        |              | 155,663       |              |
| Less - accumulated amortization |            | (16,676,459 ) |              | (15,490,920 ) |              |
| Amortized cost                  |            | 1,439,273     |              | 2,354,104     |              |
| Trademarks (indefinite lives)   |            | 799,000       |              | 799,000       |              |
| Net book value                  |            | \$ 2,238,273  |              | \$ 3,153,104  |              |

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AROTECH CORPORATION AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 7:— GOODWILL AND OTHER INTANGIBLE ASSETS, NET (Cont.)

Amortization expense amounted to \$1,185,539 and \$1,905,097 for the years ended December 31, 2012 and 2011, respectively, including amortization of capitalized software costs of \$460,085 and \$603,393, respectively.

c. Estimated amortization expenses for the years shown is as follows:

|       | Year ending<br>December 31, |
|-------|-----------------------------|
| 2013  | \$ 1,089,442                |
| 2014  | 231,160                     |
| 2015  | 27,000                      |
| 2016  | —                           |
| Total | \$ 1,347,602                |

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 income on the Balance Sheet.

NOTE 8:— SHORT-TERM BANK CREDIT AND LOANS

The Company has \$10,723,000 authorized in credit lines from certain banks, of which \$723,000 is denominated in NIS (\$168,000 was outstanding as of December 31, 2012) and carries various interest rates up to 8.2%. The primary line of \$10,000,000, subject to borrowing base limitations and outstanding letters of credit, is denominated in U.S. dollars. This line carries an interest rate of 30 day LIBOR plus 375 basis points which was 3.96% as of December 31, 2012. As of December 31, 2012, \$9,620,000 was borrowed under the Company's primary line. Approximately \$380,000 of credit on the primary line was available at December 31, 2012. The Company's primary credit facility and the Company's building mortgage with the same bank contains certain covenants, including limiting the Company's distributions to Arotech affiliates to \$4,000,000, and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0. The Company was in compliance with both of these covenants at December 31, 2012. Additionally, the loan is collateralized by the assets of Arotech and its subsidiaries.

In February 2013, to support the Company's growth, our primary bank increased the Company's credit line by 50%, from \$10,000,000 to \$15,000,000, and the expiration of the credit line was extended to May 31, 2015. The new credit agreement carries an interest rate of 30 day LIBOR plus 375 basis points and an unused line of credit fee of 0.35%. The new credit agreement also contains certain covenants, which are measured on a rolling twelve-month basis, limiting the Maximum Increase in Net Advance to Affiliates to less than 90% of EBITDA and meeting a Fixed Charge Coverage Ratio of not less than 1.1 to 1.0. It is expected that the Company will be in compliance with these covenants during 2013.

Previously, the Company had a \$10.0 million credit facility with another bank that expired April 30, 2012 and a building mortgage with the same bank which contained certain covenants, including limiting the Company's distributions to Arotech affiliates, limiting the Company's operating cash flow to total fixed charges to a ratio of 1.25 to 1.00 and limiting the Company's total liabilities to adjusted tangible net worth to a ratio of 2.50 to 1.00.

## NOTE 9:— OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

The following is a summary of other accounts payable and accrued expenses as of December 31, 2012 and 2011:

|                                | December 31, |              |
|--------------------------------|--------------|--------------|
|                                | 2012         | 2011         |
| Employees and payroll accruals | \$ 3,003,048 | \$ 2,083,209 |
| Accrued vacation pay           | 811,910      | 758,093      |
| Accrued expenses               | 369,800      | 530,079      |
| Government authorities         | 68,152       | 262,752      |
| Total                          | \$ 4,252,910 | \$ 3,634,133 |



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 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 10:— COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

Under Epsilor-EFL's research and development agreements with the Office of the Chief Scientist ("OCS"), and pursuant to applicable laws, Epsilor-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 1999 also bear interest at the LIBOR rate.) Epsilor-EFL is obligated to pay royalties only on sales of products in respect of which OCS participated in their development. Should the project fail, Epsilor-EFL will not be obligated to pay any royalties or refund the grants.

Royalties paid or accrued for the years ended December 31, 2012 and 2011 to the OCS amounted to zero and \$1,946, respectively.

b. Lease commitments:

The Company rents its 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:

| Minimum rental payments | December 31  |
|-------------------------|--------------|
| 2013                    | \$ 860,306   |
| 2014                    | 441,333      |
| 2015                    | 362,624      |
| 2016                    | 366,959      |
| 2017                    | 371,294      |
| Thereafter              | 98,266       |
| Total                   | \$ 2,500,782 |

Total rent expenses for the years ended December 31, 2012 and 2011 were \$924,864 and \$901,216, 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 property and equipment.

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

| Leased Assets                  | December 31, |           |
|--------------------------------|--------------|-----------|
|                                | 2012         | 2011      |
| Equipment                      | \$ 77,654    | \$ 77,654 |
| Less: Accumulated depreciation | (77,654 )    | (52,164 ) |
| Net book value                 | \$ —         | \$ 25,490 |

There are no remaining capital lease obligations.

c. Guarantees:

The Company obtained bank guarantees in the amount of \$427,783 in connection with (i) obligations of one 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.

d. Liens:

As security for compliance with the terms related to the investment grants from the State of Israel, Epsilor-EFL has 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 its assets, in favor of the State of Israel.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

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

The Company has \$723,000 in credit liens collateralized by the assets of the Company and guaranteed by the Company.

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

e. Litigation and other claims:

As of the date of this filing, there were no material pending legal proceedings against the Company.

NOTE 11:— LONG TERM DEBT

a. Subordinated convertible notes due August 15, 2011:

In August 2008, the Company issued \$5,000,000 in 10% subordinated convertible notes due August 15, 2011 (the “Notes”). The Notes were convertible at the option of the holders at a fixed conversion price of \$2.24. The principal amount of the Notes was 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 were met. The failure to meet such conditions could have made the Company unable to pay its Notes, causing it to default.

As of December 31, 2011, the Notes were paid in full and all associated warrants had expired.

b. Mortgage Note, Ann Arbor, Michigan:

In July 2011, the Simulation and Training Division purchased a building for \$1,500,000 containing both office and lab space. The building was financed with a \$1,100,000 mortgage loan that was obtained through the Company’s primary bank. The note requires a payment (principal and interest) of approximately \$8,000 per month at an interest rate of LIBOR plus 375 basis points per annum with a balloon payment due in May 2017. In December 2012, FAAC leased surplus space of the purchased building to a non-profit organization for \$6,300 per month as office space for a term of 10 years with an option to terminate the lease with a one year prior notice in May 2018. (See Note 8 for the relevant covenants relating to the mortgage.)

c. Mortgage Note, Auburn, Alabama:

In March 2007, the Company purchased space for the now-discontinued Armor Division in Auburn, Alabama for approximately \$1,100,000 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 8.0% per annum. The Company is currently leasing this building to the buyer of the Armor Division for approximately \$9,300 per month under a three year lease.

d. Term loans, Israel:

In February 2012, the Company negotiated a short term loan with a local bank in Israel. The funds were released to the Company in three tranches of \$250,000 each in February, March and April 2012. The interest rate for this loan is prime plus 1.2% and will be repaid in three tranches in February, March and April 2013. The balance of this loan as of December, 2012 was \$811,834. The Company has additional long term debt outstanding of approximately \$2,000 for a vehicle loan. This amount is payable in 2013.

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In U.S. dollars

## NOTE 11:– LONG TERM DEBT (Cont.)

## e. Minimum loan payments:

| Minimum loan payments | Continuing   | Discontinued |
|-----------------------|--------------|--------------|
| 2013                  | \$ 888,839   | \$ 59,287    |
| 2014                  | 55,000       | 40,382       |
| 2015                  | 55,000       | 43,734       |
| 2016                  | 55,000       | 47,356       |
| 2017                  | 55,000       | 781,341      |
| Thereafter            | 772,917      | –            |
| Total                 | \$ 1,881,756 | \$ 972,100   |

## NOTE 12:– COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Billings in excess of costs generated under the percentage-of-completion method are recorded as deferred revenues until the revenue recognition criteria are met. Deferred revenues include unearned amounts received under maintenance and support services, customer deposits of \$16,202 and \$55,201 for 2012 and 2011 respectively, and billing in excess of costs and estimated earnings on uncompleted contracts.

The following is a summary of the costs and estimated earnings on uncompleted contracts as of December 31, 2012 and 2011. Open contracts are expected to be completed in the following year:

|   | Year ended December 31, |               |
|---|-------------------------|---------------|
|   | 2012                    | 2011          |
| Costs incurred on uncompleted contracts                     | \$ 111,128,026          | \$ 82,310,317 |
| Estimated earnings  | 18,649,855              | 18,064,955    |
|   | 129,777,881             | 100,375,272   |
| Less billings to date                                       | (117,503,299)           | (96,059,555 ) |
| Total   | \$ 12,274,582           | \$ 4,315,717  |
| Unbilled receivables  | \$ 13,374,004           | \$ 5,722,781  |
| Billings in excess of costs (included in deferred revenues) | (1,099,422 )            | (1,407,064 )  |
| Total   | \$ 12,274,582           | \$ 4,315,717  |

## 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 its 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. Due to certain exercise price reset provisions, the warrants were accounted for as liabilities at fair value with changes in fair value reflected as financial income or expense.

The Notes were fully paid and the warrants expired unexercised on August 15, 2011.

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In U.S. dollars

NOTE 13:— STOCKHOLDERS' EQUITY (Cont.)

c. The Company has adopted the following stock award 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. Each restricted stock unit is equal to one share of Company stock and is redeemable only for stock. Under the terms of the award 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. 2007 Non-Employee Director Equity Compensation Plan – 750,000 shares reserved for issuance, of which 400,307 were available for future grants to outside directors as of December 31, 2012.

2. 2009 Equity Incentive Plan – 5,000,000 shares reserved for issuance, of which 3,265,555 were available for future grants to employees and consultants as of December 31, 2012.

3. 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 and restricted stock units 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 and restricted stock units generally revert back to the Company.

4. Deferred stock compensation is amortized and recorded as compensation expense ratably over the vesting period of the option or the restriction period of the restricted shares and restricted stock units. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options, restricted shares and restricted stock units to employees and directors in 2012 and 2011 was \$447,680 and \$408,492, respectively. The calculated intrinsic value of vested and unvested options for 2012 and 2011 was zero.

5. A summary of the status of the Company's plans and other share options, restricted shares and restricted stock units granted as of December 31, 2012 and 2011, and changes during the years ended on those dates, is presented below:

Stock Options:

|  | 2012      |                                       | 2011       |                                       |
|--|-----------|---------------------------------------|------------|---------------------------------------|
|  | Amount    | Weighted<br>average<br>exercise price | Amount     | Weighted<br>average<br>exercise price |
| Options outstanding at beginning of year | 64,953    | \$ 7.80                               | 186,714    | \$ 6.36                               |
| Changes during year:                     |           |                                       |            |                                       |
| Granted                                  | —         | —                                     | —          | —                                     |
| Exercised                                | —         | —                                     | —          | —                                     |
| Forfeited                                | (52,725 ) | 8.34                                  | (121,761 ) | 5.60                                  |

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|                                    |        |         |        |         |
|------------------------------------|--------|---------|--------|---------|
| Options outstanding at end of year | 12,228 | \$ 5.46 | 64,953 | \$ 7.80 |
| Options vested at end of year      | 12,228 | \$ 5.46 | 64,953 | \$ 7.80 |

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 13:— STOCKHOLDERS' EQUITY (Cont.)

Restricted Shares and Restricted Stock Units:

|   |            | 2012   |            | 2011   |
|---|------------|--|------------|--|
|   | Shares     | Weighted<br>average fair<br>value at grant<br>date | Shares     | Weighted<br>average fair<br>value at grant<br>date |
| Non-vested at the beginning of the year | 636,488    | \$ 1.43  | 406,813    | \$ 1.60  |
| Changes during year:                    |            |  |            |  |
| Restricted stock granted                | 517,582    | \$ 1.17  | 414,284    | \$ 1.32  |
| Restricted units granted                | 60,000     | \$ 1.67  | 120,000    | \$ 1.67  |
| Vested                                  | (310,497 ) | \$ 1.29  | (304,609 ) | \$ 1.47  |
| Forfeited                               | (59,303 )  | \$ 1.49  | —          | \$—  |
| Non-vested at the end of the year       | 844,270    | \$ 1.30  | 636,488    | \$ 1.43  |
| Restricted shares vested at end of year | 2,353,996  | \$ 1.97  | 2,043,499  | \$ 2.07  |

6. The remaining total compensation cost related to non-vested restricted share and restricted stock unit awards not yet recognized (before applying a forfeiture rate) in the income statement as of December 31, 2012 was \$327,750. The weighted average period over which this compensation cost is expected to be recognized is approximately two years.

7. 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 unless a net loss is reported, in which situation unvested stock awards are excluded from the number of shares outstanding for both basic and diluted earnings per share calculations..

NOTE 14:— INCOME TAXES

a. General:

As of December 31, 2012, Arotech has net operating loss carryforwards for U.S. federal income tax purposes of \$43,300,000, which are available to offset future taxable income, if any, expiring in 2020 through 2032. Utilization of U.S. net operating losses is subject to substantial annual limitations due to the “change in ownership” provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

At December 31, 2012, the Company had net deferred tax assets before valuation allowance of \$43,942,000. 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 allowance 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 IRC Section 382 changes that have occurred. 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.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 14:— INCOME TAXES (Cont.)

The Company has indefinite-lived intangible assets consisting of trademarks 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.

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 has also reevaluated its income tax positions under FASB ASC 740-10 as of December 31, 2012 and the Company believes that it has no material uncertain tax positions and therefore has no uncertain tax position reserves and does not expect to provide for any such reserves. The Company does not believe that the unrecognized tax benefits will change within 12 months of this reporting date. It is the Company’s policy that any assessed penalties and interest on uncertain tax positions would be charged to income tax expense.

The Company does not provide for U.S. federal income taxes on the undistributed earnings of its foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

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 2009, although carryforward losses that were generated prior to 2010 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 2007.

The Company files consolidated tax returns for its U.S. entities.

b. Israeli subsidiary (Epsilor-EFL):

Effective January 1, 2011 Epsilor-EFL’s tax rate was 10% in 2011 and 2012 and will be reduced to 6% by 2015. In addition, dividends paid from the profits of Epsilor-EFL are subject to tax at the rate of 15% in the hands of their recipient and tax exempt on dividends paid to Israeli company. As of December 31, 2012, there are no tax exempt profits earned by Epsilor-EFL by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2012. Furthermore, management has indicated that it has no intention of declaring any dividend.

c. Merger of Epsilor and EFL:

On June 25, 2009, two of the Company’s Israeli subsidiaries, Epsilor and EFL, entered into a merger agreement pursuant to which EFL merged all of its assets and liabilities into Epsilor, with Epsilor the survivor of the merger (the

“Merged Company”).

Through the merger date, EFL accumulated certain tax losses (the “EFL Loss”). 20% of the EFL Loss was cancelled and is not available to offset any future income. The remaining amount of the EFL Loss (the “Remaining Loss”) was absorbed into the Merged Company and is available to offset the Merged Company’s income after July 1, 2009; provided that for the 16 tax years following the merger, losses will not be available to offset the Merged Company’s income in excess of the lesser of (i) 6.25% of the original amount of the Remaining Loss, or (ii) 50% of the Merged Company’s total taxable income in that year prior to giving effect to the application of any of the EFL Loss.

As of December 31, 2012, the Merged Company has tax loss carryforwards, generated by EFL, of \$84,000,000, which is available indefinitely to offset future taxable income.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

## NOTE 14:— INCOME TAXES (Cont.)

## d. Consolidated 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:

|   | December 31,  |               |
|---|---------------|---------------|
|   | 2012          | 2011          |
| U.S. operating loss carryforward              | \$ 17,286,287 | \$ 16,420,226 |
| Foreign operating loss carryforward           | 21,366,068    | 20,938,603    |
| Total operating loss carryforward             | 38,652,355    | 37,358,829    |
| Temporary differences:                        |               |               |
| Compensation and benefits                     | 2,026,176     | 1,895,519     |
| Warranty reserves                             | 1,005,118     | 1,033,796     |
| Foreign temporary differences                 | 797,247       | 948,720       |
| All other temporary differences               | 1,461,543     | 2,443,919     |
| Total temporary differences                   | 5,290,084     | 6,321,954     |
| Deferred tax asset before valuation allowance | 43,942,439    | 43,680,783    |
| Valuation allowance                           | (43,942,439)  | (43,680,783)  |
| Total deferred tax asset                      | \$ —          | \$ —          |
| Deferred tax liability                        | \$ 4,920,021  | \$ 4,321,521  |

The Company provided valuation allowances for the 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 operating loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance during 2012 was \$261,000.

## e. Loss from continuing operations before taxes on income are as follows:

|          | Year ended December 31 |                |
|----------|------------------------|----------------|
|          | 2012                   | 2011           |
| Domestic | \$ 260,481             | \$ (1,965,158) |
| Foreign  | (1,660,719)            | (1,389,392)    |
|          | \$ (1,400,238)         | \$ (3,354,550) |

## f. Taxes on income were comprised of the following:

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|                               | Year ended December 31 |              |
|-------------------------------|------------------------|--------------|
|                               | 2012                   | 2011         |
| Current federal taxes         | \$ —                   | \$ —         |
| Current state and local taxes | 29,656                 | (69,734 )    |
| Deferred taxes                | 598,500                | 1,678,345    |
| Expense                       | \$ 628,156             | \$ 1,608,611 |
| Domestic                      | \$ 628,156             | \$ 959,027   |
| Foreign                       | —                      | 649,584      |
| Expense                       | \$ 628,156             | \$ 1,608,611 |

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

NOTE 14:— INCOME TAXES (Cont.)

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

|   | Year ended December 31, |                |
|---|-------------------------|----------------|
|   | 2012                    | 2011           |
| Loss from continuing operations before taxes                              | \$ (1,400,238)          | \$ (3,354,550) |
| Statutory tax rate  | 34 %                    | 34 %           |
| Theoretical income tax on the above amount at the U.S. statutory tax rate | \$ (476,081 )           | \$ (1,140,547) |
| Deferred taxes for which valuation allowance was provided                 | 860,390                 | 2,685,812      |
| Non-deductible credits  | 64,726                  | 8,035          |
| State taxes, net of federal benefit                                       | 29,656                  | (69,734 )      |
| Foreign income in tax rates other than U.S. rate                          | 149,465                 | 125,045        |
| Actual tax expense  | \$ 628,156              | \$ 1,608,611   |

NOTE 15:— SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expense), net:

|  | Year ended December 31, |               |
|--|-------------------------|---------------|
|  | 2012                    | 2011          |
| Financial expenses:                      |                         |               |
| Interest, bank charges and fees          | \$ (588,678 )           | \$ (350,330 ) |
| Debt discount amortization               | —                       | (39,351 )     |
| Foreign currency transaction differences | (9,701 )                | (279,190 )    |
| Other                                    | (15,668 )               | (4,473 )      |
| Total financial expenses                 | (614,047 )              | (673,344 )    |
| Financial income:                        |                         |               |
| Interest                                 | —                       | 114,925       |
| Foreign currency transaction differences | 66,061                  | 208           |
| Change in derivative values              | —                       | 226,954       |
| Other                                    | —                       | 251           |
| Total financial income                   | 66,061                  | 342,338       |
| Total financial income (expense), net    | \$ (547,986 )           | \$ (331,006 ) |

NOTE 16:— SEGMENT INFORMATION

a. General:

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

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

## NOTE 16:– SEGMENT INFORMATION (Cont.)

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 on two primary factors: the segment's operating income and 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<br>Simulation<br>Division | Battery and<br>Power<br>Systems<br>Division | Corporate<br>Expenses | Discontinued<br>operations | Total<br>Company |
|--|--|---|-----------------------|----------------------------|------------------|
| 2012                                       |  |   |                       |                            |                  |
| Revenues from outside customers            | \$59,270,768                           | \$20,779,666                                | \$–                   | \$–                        | \$80,050,434     |
| Depreciation and amortization expenses (1) | (1,105,958 )                           | (1,118,104 )                                | (48,655 )             | –                          | (2,272,717 )     |
| Direct expenses (2)                        | (53,055,151 )                          | (19,974,339 )                               | (5,600,479 )          | –                          | (78,629,969 )    |
| Segment net income (loss)                  | 5,109,659                              | (312,777 )                                  | (5,649,134 )          | –                          | (852,252 )       |
| Financial expenses                         | (43,221 )                              | (7,639 )                                    | (497,126 )            | –                          | (547,986 )       |
| Income tax expense (benefit)               | (7,688 )                               | –   | 635,844               | –                          | 628,156          |
| Net income (loss) – continuing operations  | 5,074,126                              | (320,416 )                                  | (6,782,104 )          | –                          | (2,028,394 )     |
| Net loss – discontinued operations         | –                                      | –   | –                     | (988,283 )                 | (988,283 )       |
| Net income (loss)                          | \$5,074,126                            | \$(320,416 )                                | \$(6,782,104 )        | \$(988,283 )               | \$(3,016,677 )   |
| Segment assets                             | \$51,302,000                           | \$26,013,955                                | \$174,791             | \$389,272                  | \$77,880,018     |
| Additions to long-lived assets             | \$550,634                              | \$734,198                                   | \$–                   | \$–                        | \$1,284,832      |
| 2011                                       |  |   |                       |                            |                  |
| Revenues from outside customers            | \$42,881,573                           | \$19,254,005                                | \$–                   | \$–                        | \$62,135,578     |
| Depreciation and amortization expenses (1) | (1,845,582 )                           | (1,094,930 )                                | (68,528 )             | –                          | (3,009,040 )     |
| Direct expenses (2)                        | (38,292,715 )                          | (18,297,385 )                               | (5,559,982 )          | –                          | (62,150,082 )    |
| Segment net income (loss)                  | 2,743,276                              | (138,310 )                                  | (5,628,510 )          | –                          | (3,023,544 )     |
| Financial income (expense)                 | (47,112 )                              | (209,764 )                                  | (74,130 )             | –                          | (331,006 )       |
| Income tax expense (benefit)               | (69,734 )                              | 646,824                                     | 1,031,521             | –                          | 1,608,611        |
| Net income (loss) – continuing operations  | 2,765,898                              | (994,898 )                                  | (6,734,161 )          | –                          | (4,963,161 )     |
| Net loss – discontinued operations         | –                                      | –   | –                     | (6,563,844 )               | (6,563,844 )     |
| Net income (loss)                          | \$2,765,898                            | \$(994,898 )                                | \$(6,734,161 )        | \$(6,563,844 )             | \$(11,527,005 )  |
| Segment assets                             | \$48,501,634                           | \$25,335,086                                | \$548,717             | \$6,716,508                | \$81,101,945     |
| Additions to long-lived assets             | \$2,124,953                            | \$911,382                                   | \$3,345               | \$97,558                   | \$3,137,238      |

- (1) Includes depreciation of property and equipment and amortization expenses of intangible assets.
- (2) Including, inter alia, sales and marketing, general and administrative, research and development and other income.

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

## NOTE 16:— SEGMENT INFORMATION (Cont.)

## c. Summary information about geographic areas:

The following presents total revenues according to the locations of the Company's end customers and long-lived assets as of and for the years ended December 31, 2012 and 2011:

|             | 2012              |                      | 2011              |                      |
|-------------|-------------------|----------------------|-------------------|----------------------|
|             | Total<br>revenues | Long-lived<br>assets | Total<br>revenues | Long-lived<br>assets |
| U.S.A.      | \$ 63,751,882     | \$ 28,879,572        | \$ 45,517,776     | \$ 29,543,962        |
| Israel      | 7,485,034         | 8,385,579            | 8,585,357         | 8,661,347            |
| Germany     | 1,517,200         | —                    | 318,892           | —                    |
| Taiwan      | 1,349,420         | —                    | 1,915,361         | —                    |
| Korea       | 1,198,663         | —                    | —                 | —                    |
| Canada      | 1,167,656         | —                    | 2,150,419         | —                    |
| Hong Kong   | 1,098,346         | —                    | —                 | —                    |
| India       | 605,966           | —                    | 8,630             | —                    |
| Mexico      | 283,584           | —                    | 150,634           | —                    |
| Ecuador     | 139,845           | —                    | —                 | —                    |
| Thailand    | 137,970           | —                    | 72,363            | —                    |
| U.A.E.      | 109,604           | —                    | 386,241           | —                    |
| China       | 98,832            | —                    | 307,120           | —                    |
| New Zealand | —                 | —                    | 731,151           | —                    |
| Kuwait      | —                 | —                    | 539,118           | —                    |
| England     | —                 | —                    | 228,669           | —                    |
| Slovenia    | —                 | —                    | 121,475           | —                    |
| Other       | 1,106,432         | —                    | 1,102,372         | —                    |
|             | \$ 80,050,434     | \$ 37,265,151        | \$ 62,135,578     | \$ 38,205,309        |

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

Other than for sales to various branches of the United States Military, which accounted for 54% and 46% of consolidated continuing revenues for 2012 and 2011, respectively, no single customer accounted for more than 10% of revenues for either year.

## e. Revenues from major products:

|                           | Year ended December 31, |               |
|---------------------------|-------------------------|---------------|
|                           | 2012                    | 2011          |
| Water activated batteries | \$ 3,786,946            | \$ 3,614,876  |
| Batteries and chargers    | 16,992,720              | 15,639,129    |
| Simulators                | 59,270,768              | 42,881,573    |
| Total                     | \$ 80,050,434           | \$ 62,135,578 |

## NOTE 17:— WARRANTY

The following is a summary of the deferred warranty revenue included in total deferred revenue as of December 31, 2012 and 2011:

|                                | Year ended December 31, |              |
|--------------------------------|-------------------------|--------------|
|                                | 2012                    | 2011         |
| Balance at beginning of period | \$ 2,557,160            | \$ 3,236,122 |
| Deferred revenue               | 2,396,807               | 1,960,540    |
| Revenue recognized             | (2,271,505)             | (2,639,502)  |
| Balance at end of period       | \$ 2,682,462            | \$ 2,557,160 |

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AROTECH CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In U.S. dollars

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II – Valuation and Qualifying Accounts

For the Years Ended December 31, 2012 and 2011

| Description                             | Balance at<br>beginning<br>of period | Reductions   | Additions | Balance at<br>end of<br>period |
|---|--------------------------------------|--------------|-----------|--------------------------------|
| Year ended December 31, 2012            |                                      |              |           |                                |
| Allowance for doubtful accounts         | \$–                                  | \$–          | \$–       | \$–                            |
| Valuation allowance for deferred taxes* | 43,681,000                           | –            | 261,000   | 43,942,000                     |
| Year ended December 31, 2011            |                                      |              |           |                                |
| Allowance for doubtful accounts         | \$–                                  | \$–          | \$–       | \$–                            |
| Allowance for settlements               | 1,553,000                            | (1,553,000 ) | –         | –                              |
| Valuation allowance for deferred taxes* | 36,629,000                           | –            | 7,052,000 | 43,681,000                     |

\*The 2012 and 2011 valuation allowance includes an adjustment to the prior year provision calculation due to changes recognized in the preparation of the actual returns.

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