

מסמך רישום

AROTECH CORPORATION

ארוטק קורפוריישן

(להלן: "החברה")

רישום למסחר של: 12,913,701 מניות רגילות רשומות על שם בנות 0.01 דולר ארה"ב ערך נקוב כל אחת (להלן: "מניות רגילות"); ועד 674,707 מניות רגילות שינבעו מממוש אופציות (Warrants) שאינן רשומות למסחר; ועד 875,000 מניות רגילות שינבעו מממושן של אופציות (Options) שאינן רשומות למסחר.

ניירות הערך של החברה רשומים למסחר בבורסה בארה"ב:

National Association of Securities Dealers Automated Quotations system – Global Market
NASDAQ-GM

סימן ניירות הערך של החברה בבורסה: ארטק

סימן ניירות הערך של החברה בבורסה בחו"ל: ARTX

ניירות הערך של החברה יירשמו למסחר לפי הוראות פרק 3 לחוק ניירות ערך, התשכ"ח-1968, ולפיכך דיווחי התאגיד יהיו בשפה האנגלית ותוכנם יהא בהתאם למתכונת הדיווח שלו בחו"ל

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2.	דו"ח שנתי של החברה לשנת 2006 מיום 17 באפריל, 2007 (FORM 10-K)
3.	תיקון דו"ח שנתי של החברה לשנת 2006 מיום 30 באפריל, 2007 (FORM 10-K/A)
4.	דיווח שפרסמה החברה ביום 1 במאי, 2007 (FORM 8-K)
5.	דיווח שפרסמה החברה ביום 1 במאי, 2007 (FORM POS AM)
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9.	דו"ח רבעוני של החברה מיום 17 במאי, 2007 (FORM 10-Q)
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11.	תיקון דו"ח שנתי של החברה לשנת 2006 מיום 13 ביוני, 2007 (FORM 10-K/A)
12.	דיווח שפרסמה החברה ביום 2 ביולי, 2007 (FORM 8-K)
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17. מסמך פרוקסי שפרסמה החברה ביום 27 באוגוסט, 2007 (FORM DEF 14A)

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חלק ראשון

1. **שם החברה:** AROTECH CORPORATION (לשעבר: "Electric fuel corporation")
2. **מקום התאגדות החברה:** מדינת דלאוור, ארה"ב.
3. **תאריך התאגדות החברה:** 20 בדצמבר 1990
4. **סוגי ניירות הערך שהנפיקה החברה:**
 - 4.1 מניות רגילות, הרשומות למסחר ב-NASDAQ-GM.
 - 4.2 מניות רגילות שינבעו ממימושן של אופציות (Warrants), שהוקצו למשקיעים, הרשומות למסחר תחת טופס S-1.
 - 4.3 מניות רגילות שינבעו ממימושן של אופציות (Options) שהוקצו לעובדים, הרשומות למסחר תחת טופס S-8.
5. **מקום רישום ניירות הערך למסחר:** National Association of Securities Dealers Automated Quotations system – Global Market (NASDAQ-GM)
6. **כמות ניירות הערך הרשומה למסחר:**
 - 6.1 12,913,701 מניות רגילות.
 - 6.2 עד 674,707 מניות רגילות שינבעו ממימוש אופציות (Warrants), הרשומות למסחר תחת טופס S-1.
 - 6.3 עד 875,000 מניות רגילות שינבעו ממימוש אופציות (Options), הרשומות למסחר תחת טופס S-8.
7. **התאריך שבו נרשמו ניירות הערך לראשונה למסחר בבורסת NASDAQ-GM:** 24 בפברואר 1994.
8. **פרטים אודות החברה:**
 - 8.1 מען רשום:
1229 Oak Valley Drive, Ann Arbor, Michigan 48108
 - 8.2 מס' טלפון ומס' פקס בישראל: 02-9906666, 02-9906688
 - 8.3 מס' טלפון ומס' פקס בחו"ל: 1-800-281-0356; 734-761-5368

9. **סימון ניירות הערך:**
- 9.1 **בבורסה בחו"ל (NASDAQ-GM): ARTX**
- 9.2 **בבורסה לניירות ערך בתל אביב בע"מ: ארטק**
10. **אנשי קשר של החברה:**
- 10.1 **איש קשר עם גופי הפיקוח והאכיפה של הדין הזר: פמלה מוריס**
- 10.2 **כתובתו של איש הקשר בחו"ל:**
The Nasdaq Stock Market, Listing Qualifications, 9600 Blackwell Road, Rockville,
MD 20850
- 10.3 **מס' טלפון ומס' פקס בחו"ל: 301-978-8055; 301-978-8053**
- 10.4 **איש קשר עם הרשות לניירות ערך: עו"ד יעקב הר-עוז**
- 10.5 **כתובתו של איש הקשר בישראל: רח' סוללה 1, אזור התעשייה המערבי, בית שמש, 99000.**
- 10.6 **מס' טלפון ומס' פקס בישראל: 02-9906688; 02-9906623**
- 10.7 **Transfer Agent: American Stock Transfer & Trust Company**
11. **תיאור המניות:**
- 11.1 **הון המניות הרשום של החברה מורכב מ-250,000,000 מניות רגילות בנות 0.01 דולר ארה"ב ערך נקוב כל אחת, ומ-1,000,000 מניות בכורה בנות 0.01 דולר ארה"ב ערך נקוב כל אחת.**
- 11.2 **הון המניות המונפק של החברה מורכב מ-12,913,701 מניות רגילות על שם בנות 0.01 דולר ארה"ב ערך נקוב כל אחת.**
- 11.3 **החברה מתחייבת, כי כל עוד מניותיה רשומות למסחר בבורסה בתל אביב היא לא תוציא, לא תקצה ולא תנפיק מניות מסוג שונה מזה הרשום למסחר בבורסה בתל אביב, למעט בהקצאה המקיימת את הוראות סעיף 46ב(א)(1) לחוק ניירות ערך, תשכ"ח-1968.**
- 11.4 **המניות זכאיות להשתתף בחלוקת מלוא דיבידנד או מניות הטבה שיוכרו עליהם לאחר תאריך מסמך רישום זה.**

12. עיקרי הזכויות הנלוות למניות של החברה

להלן תיאור של עיקרי הזכויות הנלוות למניות הרגילות של החברה על פי ה-Articles of Incorporation וה-¹Bylaws של החברה (להלן ביחד: "מסמכי ההתאגדות").

האמור להלן הינו תיאור כוללני שאינו מתיימר להיות תיאור ממצה או פרשנות מוסמכת של הדין ואינו מהווה תחליף לעיון ב-Articles of Incorporation וה- Bylaws של החברה.

12.1 **הזכות להשתתף בחלוקת דיבידנדים** – בעלי המניות זכאים להשתתף בחלוקת דיבידנד על ידי החברה.

12.2 **אסיפות בעלי מניות**

12.2.1 **זכות הצבעה** – כל בעל מניות רשום של החברה זכאי בכל אסיפת בעלי מניות לקול אחד עבור כל מניה הרשומה על שמו במרשם בעלי המניות.

12.2.2 **זימון אסיפות** – מועד ומיקום האסיפה השנתית יקבעו על ידי הדירקטוריון, אשר ישלח הודעה על כך לבעלי המניות. באסיפה זו יבחרו דירקטורים ויתקבלו החלטות נוספות הנדרשות על פי חוק או ב- Bylaws. ניתן לכנס אסיפה מיוחדת של בעלי המניות לבקשת יו"ר הדירקטוריון או מזכיר החברה. על פי חוקי מדינת דלאוור, ובהעדר הוראה במסמכי ההתאגדות של החברה, דירקטוריון החברה רשאי לזמן אסיפה מיוחדת של בעלי המניות של החברה. האמור לעיל שונה מהדין בישראל, לפיו גם לבעל מניות, בתנאים מסוימים הקבועים בדין, זכות לדרוש כינוס אסיפה מיוחדת.

12.2.3 **הודעה על זימון אסיפה** – למעט במקרים הקבועים בחוק, לכל בעל מניות תינתן הודעה בכתב על כל אסיפה ובה פרטי מועד ומיקום האסיפה, ובמקרים של אסיפות מיוחדות תצוין גם מטרת האסיפה. ההודעה תימסר לא פחות מעשרה ימים ולא יותר משישים ימים טרם מועד האסיפה.

12.2.4 **מניין חוקי** – על פי חוקי מדינת דלאוור ועל פי מסמכי ההתאגדות של החברה, המניין החוקי לכינוס אסיפה יתהווה בנוכחות רוב רגיל של הזכאים להצביע, למעט במקרים בהם דרוש רוב גדול יותר על פי חוק או על פי מסמכי ההתאגדות.

12.2.5 **החלטה ללא אסיפה** – כל פעולה שנדרש לגביה אישור האסיפה הכללית או שניתן לקבל לגביה אישור של האסיפה הכללית, יכולה להתקבל ללא כינוס האסיפה. ההחלטה תתקבל כשהיא חתומה על ידי רוב בעלי המניות המחזיקים בזכויות הצבעה, אלא אם נדרש יחס הצבעה שונה לשם קבלת ההחלטה הנדונה. אישור האסיפה הכללית כאמור יכנס לתוקף בתנאי שתישלח הודעה ערוכה בהתאם להוראות הדין ליתר בעלי המניות אשר לא השתתפו בקבלת ההחלטה.

¹לפי חוקי מדינת דלאוור, ה- Certificate of Incorporation יתוקן בהתאם לאישור דירקטוריון החברה ורוב המניות הזכאיות להצביע (אלא אם נקבע ב- Certificate of Incorporation רוב גדול יותר, ב- Certificate of Incorporation של החברה לא נקבע כאמור). ה- Bylaws של החברה קובע כי הוא יתוקן, ישונה או יבוטל על ידי רוב המניות הזכאיות להצביע.

- 12.3 **מינוי ופיטור דירקטורים:** לפי חוקי מדינת דלאוור ולפי מסמכי ההתאגדות של החברה, חברי הדירקטוריון ומספרם ייקבע באסיפה שנתית של בעלי המניות, ובעלי המניות יכולים להעביר דירקטורים מכהונתם בכל עת.
- 12.4 לפי חוקי מדינת דלאוור העברת דירקטור מתפקידו יכולה להיות הן בגין עילה ואף ללא עילה. עם זאת, חוקי מדינת דלאוור קובעים כי במקרה בו לחברה יש דירקטוריון מסווג (כמו לחברה דנן, ראה סעיף 12.7.1 להלן), העברת דירקטור מתפקידו יכולה להיות רק בשל עילה מוצדקת (אלא אם נקבע אחרת). במסמכי ההתאגדות של החברה נקבע כי העברת דירקטור מתפקידו יכולה להיות בגין עילה מוצדקת בלבד, בכל אסיפה (רגילה או מיוחדת) של בעלי המניות בהצבעה ברוב של לפחות 85% מבעלי המניות הזכאים להצביע.
- בהתאם לדין בדלאוור ועל פי מסמכי ההתאגדות של החברה, מקום המתפנה בדירקטוריון יתמלא, ככלל, בהצבעת בעלי המניות באסיפה שכונסה לצורך כך או בהצבעה של רוב הדירקטורים המכהנים.
- בהתאם להוראות חוק החברות הישראלי, אסיפת בעלי המניות יכולה להעביר דירקטור מתפקידו (אלא אם נקבע אחרת בתקנון) בכל עת ובלבד שתינתן לו הזדמנות סבירה להביע את עמדתו, וכן, במקרה בו הדירקטור הורשע בעבירות מסוימות, לפי החלטת בית משפט או אם הוכרז כפושט רגל.
- 12.5 **פירוק** – במקרה של פירוק, יהיו בעלי המניות בחברה זכאים לחלק בר הערכה בנכסי החברה (נטו) הניתנים לחלוקה לבעלי המניות, לאחר תשלום חובות והתחייבויות החברה ותשלום לבעלי מניות בכורה, בהתאם לזכויותיהם כפי שנקבעו במסמכי ההתאגדות או על ידי דירקטוריון החברה בהתאם לסמכותו.
- 12.6 התנאים לשינוי הזכויות הנלוות למניות – מסמכי ההתאגדות אינם קובעים הוראות באשר לשינוי הזכויות הנלוות למניות החברה. לפיכך, בהתאם לחוקי מדינת דלאוור, שינוי הזכויות יכול להעשות רק באמצעות שינוי ה – Certificate Of Incorporation – ראה ה"ש 1.
- לפי חוק החברות, חברה ישראלית שהתאגדה לפני ה-1 בפברואר 2000, המועד בו נכנס חוק החברות לתוקף, רשאית לתקן את תקנון ההתאגדות שלה בהחלטה שנתקבלה באסיפה הכללית ברוב של 75% מן המשתתפים בהצבעה, או ברוב אחר אם נקבע בתזכיר או בתקנון.
- 12.7 **הגנה מפני השתלטות:** בהתאם למסמכי ההתאגדות של החברה קיימים המנגנונים הבאים:
- 12.7.1 בהתאם לחוק מדינת דלאוור, ניתן לקבוע כי רק חלקים מהדירקטוריון ימונו בכל שנה. במסמכי ההתאגדות של החברה נקבע כי דירקטוריון החברה מחולק לשלושה סוגי דירקטורים, המשרתים בתקופה כוללת של שלוש שנים, כאשר רק שליש מהדירקטוריון מוחלף מדי שנה;
- 12.7.2 בעלי המניות יכולים להעביר דירקטורים מכהונתם רק בגין עילה מוצדקת, ורק ברוב של לפחות 85% (ראה סעיף 12.3 לעיל).
- 12.7.3 לדירקטוריון החברה הסמכות להנפיק מניות בכורה ולקבוע את הזכויות הנלוות להן. למועד פרסום מסמך הרישום לא הונפקו מניות בכורה על ידי החברה ולחברה אין כוונה להנפיק מניות אלו. ראו גם את התחייבות החברה בסעיף 11.3 לעיל.

13. דרך ההצבעה באסיפות בעלי מניות של החברה

עד שייקבע אחרת על ידי החברה, הצבעה של בעל מניה אשר מניותיו מוחזקות בחשבון המסלקה ב-DTCC (Depository Trust & Clearing Corporation), באסיפת בעלי מניות של החברה, תתאפשר עם המצאת "אישור בעלות" לחברה על ידי בעל המניה לגבי החזקת מניות במועד הקובע להשתתפות באסיפה, כשהוא חתום על ידי חבר המסלקה שבאמצעותו מחזיק בעל המניה את המניה בחברה. בעל מניה שיצביע באמצעות כתב הצבעה, שיפורסם על ידי החברה באמצעות המגנ"א, יצרף את אישור הבעלות לכתב ההצבעה.

נקבעה אסיפה כללית של בעלי מניות, תפנה החברה למסלקת הבורסה בבקשה לקבל את יתרת המניות הרשומה לזכות כל אחד מחברי המסלקה ביום שנקבע על ידי החברה כיום הקובע לצורך הצבעה באסיפה הכללית (להלן: "היום הקובע") ולקבלת ייפוי כח מהמסלקה, שנועד לאפשר לזכאים לממש את הזכות להצביע באסיפה הכללית.

החברה קיבלה חוות דעת של עו"ד אמריקאי לפיה דרך ההצבעה המפורטת בסעיף 13 זה לעיל, עולה בקנה אחד עם דרישת הדינים המחייבים בארה"ב החלים על החברה.

14. אישור הבורסה לניירות ערך בתל אביב בע"מ

הבורסה לניירות ערך בתל אביב בע"מ נתנה את אישורה לרישום למסחר של המניות והמניות שתנבענה מממוש האופציות, (כמפורט בסעיף 6 לעיל) הנרשמות על פי מסמך רישום זה, כאמור לעיל. אין לראות באישור כאמור של הבורסה אישור לפרטים המובאים במסמך רישום זה, או לשלמותם ואין בו משום הבעת דעה על החברה או על טיבם של ניירות הערך הנרשמים על פי מסמך רישום זה.

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PROSPECTUSFiled pursuant to Rule 424(b)(1)
Registration File No. 333-133697**4,360,721 Shares
Common Stock**

This prospectus relates to the offer and sale of up to 4,360,721 shares of the common stock of Arotech Corporation from time to time by the selling stockholders listed in this prospectus.

Our common stock is listed on the Nasdaq Global Market under the symbol "ARTX." The last reported sale price for our common stock on August 24, 2006 as quoted on the Nasdaq Global Market was \$2.49 per share.

Investing in our common stock involves a high degree of risk. See "Risk Factors" on page 10 for various risks that you should consider before you purchase any shares of our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is August 25, 2006

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Unless the context otherwise requires, references to us refer to Arotech Corporation and its subsidiaries.

You may only rely on the information contained in this prospectus or that we have referred you to. We have not authorized anyone to provide you with different information. This prospectus does not constitute an offer to sell or a solicitation of an offer to buy any securities other than the common shares offered by this prospectus. This prospectus does not constitute an offer to sell or a solicitation of an offer to buy any common shares in any circumstances in which such offer or solicitation is unlawful. Neither the delivery of this prospectus nor any sale made in connection with this prospectus shall, under any circumstances, create any implication that there has been no change in our affairs since the date of this prospectus or that the information contained by reference to this prospectus is correct as of any time after its date.

On June 21, 2006, we effected a one-for-fourteen reverse stock split. All share numbers, share prices and exercise and conversion amounts and prices appearing in this prospectus have been adjusted to reflect this reverse stock split.

SUMMARY

The following summary highlights some information from this prospectus. It is not complete and does not contain all of the information that you should consider before making an investment decision. You should read this entire prospectus, including the “Risk Factors” section, the financial statements and related notes and the other more detailed information appearing elsewhere or incorporated by reference in this prospectus. Unless otherwise indicated, “we,” “us,” “our” and similar terms refer to Arotech Corporation and its subsidiaries and not to the Selling Stockholders.

Arotech™ is a trademark, and Electric Fuel® is a registered trademark, that belongs to us. All company and product names mentioned may be trademarks or registered trademarks of their respective holders.

About Us

We are a defense and security products and services company, incorporated in Delaware in 1990, engaged in three business areas: high-level armoring for military and nonmilitary air and ground vehicles; interactive simulation for military, law enforcement and municipal markets; and batteries and charging systems for the military. We operate primarily through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned by us, unless otherwise noted) are as follows:

- We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our ***Simulation and Training Division***:
 - We provide simulators, systems engineering and software products to the United States military, government and private industry through our subsidiary FAAC Incorporated, located in Ann Arbor, Michigan (“FAAC”); and
 - We provide specialized “use of force” training for police, security personnel and the military through our subsidiary IES Interactive Training, Inc., located in Ann Arbor, Michigan (“IES”).
- We utilize sophisticated lightweight materials and advanced engineering processes to manufacture aviation armor and to armor vehicles through our ***Armor Division***:
 - We manufacture ballistic and fragmentation armor kits for rotary and fixed wing aircraft and marine armor through our subsidiary Armour of America, located in Auburn, Alabama (“AoA”); and
 - We use state-of-the-art lightweight armoring materials, special ballistic glass and advanced engineering processes to fully armor military and civilian SUV’s, buses and vans, through our subsidiaries MDT Protective Industries, Ltd., located in Lod, Israel (“MDT”), of which we own 75.5%, and MDT Armor Corporation, located in Auburn, Alabama (“MDT Armor”), of which we own 88%.
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles through our ***Battery and Power Systems Division***:
 - We develop and sell rechargeable and primary lithium batteries and smart chargers to the military and to private defense industry in the Middle East, Europe and Asia through our subsidiary Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel’s Negev desert area) (“Epsilor”);
 - We manufacture and sell Zinc-Air batteries and battery electronics for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama (“EFB”); and
 - We produce water-activated lifejacket lights for commercial aviation and marine applications, and we conduct

our Electric Vehicle effort, through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel (“EFL”).

Simulation and Training Division

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 Simulation and Training Division, the largest of our three divisions. During 2005, 2004 and 2003 revenues from our Simulation and Training Division were approximately \$26.8 million, \$21.5 million and \$8.0 million, respectively (on a pro forma basis, assuming we had owned all components of our Simulation and Training Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$26.8 million, \$21.5 million and \$17.9 million, respectively).

VEHICLE DRIVING SIMULATORS AND INCIDENT COMMAND TRAINING

We conduct our vehicle simulator business in two primary areas: Vehicle Driving Simulations, which focuses on the development and delivery of complete driving simulations for a wide range of vehicle types - such as trucks, automobiles, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles - for municipal, governmental and foreign customers; and Military Operations, which conducts tactical air and land combat analysis and develops analytical models, simulations, and "turnkey" training systems for the U.S. military. In 2005, Vehicle Simulations accounted for approximately 85% of our vehicle simulation revenues, and Military Operations accounted for approximately 15% of our vehicle simulation revenues.

In the area of Military Operations, we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare 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 ranges (such as Top Gun) to full task training devices such as the F-18 Weapon Tactics Trainer. We are also the leading supplier of wheeled vehicle simulators to the U.S. Armed Forces for mission-critical vehicle training.

We supply on-board software to support weapon launch decisions for the F-15, F-18, and Joint Strike Fighter (JSF) fighter aircraft. Pilots benefit by having highly accurate presentations of their weapon's capabilities, including susceptibility to target defensive reactions. We designed and developed an instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system. The special operational forces aircrew training system provides a full range of aircrew training, including initial qualification, mission qualification, continuation, and upgrade training, as well as combat mission rehearsal.

USE-OF-FORCE TRAINING

We are a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, security, military and similar applications. With a customer base of over 700 customers in over twenty countries around the world, we are a leader in the supply of simulation training products to military, law enforcement and corporate client communities. We believe, based on our general knowledge of the size of the interactive use-of-force market, our specific knowledge of the extent of our sales, and discussions we have held with customers at trade shows, etc., that we provide more than 25% of the world-wide market for government and military judgment training simulators. We conduct our interactive training activities through our subsidiary IES Interactive Training, Inc. ("IES"), a Delaware corporation based in Ann Arbor, Michigan.

We offer consumers the following interactive training products and services:

- *Range 3000* - providing use-of-force simulation for military and law enforcement. We believe that the Range 3000 is the most technologically advanced judgment training simulator in the world.
- *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.

- *Range FDU (Firearms Diagnostic Unit)* - a unique combination of training and interactive technologies that give instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.
- *Milo (Multiple Interactive Learning/training Objectives)* - a simulator designed with “plug in” modules to customize the training system to meet end user needs.
- *Summit Training International* - providing relevant, cost-effective professional training services and interactive courseware for law enforcement, corrections and corporate clients.
- *IES Studio Productions* - providing cutting edge multimedia video services for law enforcement, military and security agencies, utilizing the newest equipment to create the training services required by the most demanding authorities.

Most of the customers for our IES products are law enforcement agencies, both in the United States (federal, state and local) and worldwide. Purchasers of IES products have included (in the United States) the FBI, the Secret Service, the Bureau of Alcohol, Tobacco and Firearms, the Customs Service, the Federal Protective Service, the Border Patrol, the Bureau of Engraving and Printing, the Coast Guard, the Federal Law Enforcement Training Centers, the Department of Health and Human Services, the California Department of Corrections, NASA, police departments in Texas (Houston), Michigan (Detroit), Washington, D.C., California (Fresno and the California Highway Patrol), Massachusetts (Brookline), Virginia (Newport News and the State Police Academy), Arizona (various counties), universities and nuclear power plants, as well as international users such as the Israeli Defense Forces, the German National Police, the Royal Thailand Army, the Hong Kong Police, the Russian Security Police, users in Mexico and the United Kingdom, and over 700 other training departments worldwide.

Armor Division

We manufacture aviation and other armor and we armor vehicles through our Armor Division. During 2005, 2004 and 2003 revenues from our Armor Division were approximately \$12.3 million, \$18.0 million and \$3.4 million, respectively (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$12.3 million, \$29.2 million and \$10.9 million, respectively).

AIRCRAFT ARMORING

Through our subsidiary Armour of America, located in Auburn, Alabama, we manufacturer ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles, architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique armored floatation vest that is certified by the U.S. Coast Guard.

We produce two kinds of armor, soft armor and hard armor, to support customer armor requirements. Soft armor, which is capable of protecting against all handguns and 9mm sub guns, is used in our ballistic and fragmentation vest, military vehicle, marine, architectural and special application armor lines. Hard armor, which is capable of protecting against rifle fire up to 50cal/12.7mm API, is used in our ballistic chest plate, aircraft, military vehicle, marine and architectural armor lines. Within these two basic kinds of armor, we offer the product lines listed below.

Fixed and Rotary Wing Aircraft Armor Systems

We design and manufacture ballistic armor systems for a wide variety of fixed and rotary wing aircraft. These systems are in the form of kits, with individual contoured panels which cover the entire aircraft's floor, walls, seats, bulkheads, walls, oxygen containers, avionics and doors. All of our ballistic armor kits include a complete installation hardware kit containing all items required for installation. The supplied hardware is designed for each individual application in accordance with the installation hardware certification, which has been provided by Lockheed-Martin. Additionally, the fixed and rotary wing aircraft kits have been certified, by an independent test facility that is approved by the FAA, to meet flammability requirements of FAA/FAR 25.853, 12 Second Vertical Test and MIL-STD-810 Environmental Testing.

Military Vehicles Armor Kits

For the military vehicle market, we provide ballistic armor kits to protect against fragmentation and rifle fire, 2½- and 5-ton trucks, HEMTT wreckers and various construction vehicles. These kits offer varying levels of protection for doors, floors, fuel tanks, air bottles, cargo beds, troop seat backs, critical components and glass. To date, we have protected vehicles deployed in Iraq, Afghanistan, and Kuwait. All of the provided kits are designed for easy field level installation and include required hardware and instructions.

Marine Armor Kits

For the marine market, we manufacture armor kits for the gun mounts on naval ships and riverine patrol boats. During Operation Desert Storm, we designed and manufactured .50 cal AP ballistic panels and deck mount brackets for the U.S. Navy. Since then, we have designed and manufactured armor to fit both the .50 cal and 25mm gun mounts on frigates, destroyers, cruisers and aircraft carriers. The result of this effort is that we have delivered armor systems to individual ships in the class and currently are pursuing armoring additional classes of ships throughout the Navy Command.

Ballistic Vests and Plates and Body Armor

We manufacture a complete line of personal body armor, including concealable, external and special application armor. The concealable armor vest offers complete front, side and back protection using soft, lightweight, high strength proprietary woven ballistic fabrics.

Our external vest line includes assault, tactical, riot, stab and T-panel designs. Each of these designs can be modified to meet the individual wearer of customer's requirements. Special application vests include the Armourfloat, which to our knowledge is currently the only ballistic/floatation vest approved by the U.S. Coast Guard; the Zip Out armor jacket, which offers covert protection in both a lightweight jacket or vest design; and our helicopter vest, which incorporates a unique protection/comfort design.

We offer a complete line of personal body armor including concealable ballistic vests, military vests and external tactical vests as well as a line of products specially designed for U.S. Navy Seal Teams and various law enforcement agencies in the United States and overseas. Our hard ballistic armor, designed to stop military rifle fire up to and including .50 caliber and European 12.7 mm Armor Piercing Incendiary (API) rounds, is used primarily on fixed and rotary wing aircraft, military ships and military vehicles, as well as in architectural applications.

We have designed and manufactured special operations personal armor including ballistic hand held shields and the LEGUARD Tactical Leg Armor, which offers complete front protection for the lower thigh, knee, shin and instep.

Other Armor for Specialty Applications

In addition to aircraft, marine, vehicle and vest armor, we also manufacture ballistic and fragmentation blankets and curtains for numerous specialty applications. These applications include operator protection around test equipment; rupture protection of pressure vessels, mechanical failure of production machinery and high pressure piping. Additionally, we have supplied armor for office use in protection of occupants from blast and glass fragments of windows and isolation of security rooms from surrounding environments.

VEHICLE ARMORING

We specialize in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs through our majority-owned subsidiaries, MDT Protective Industries Ltd., located in Lod, Israel, and MDT Armor Corporation, located in Auburn, Alabama. We are a leading supplier to the Israeli military, Israeli special forces and special services. Our products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide.

We have acquired many years of battlefield experience in Israel. Our vehicles have provided proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings. In

fact, to our knowledge an MDT-armored vehicle has never experienced bullet penetration into a vehicle cabin under attack. We also use our technology to protect vehicles against vandalism.

In 2003, we established MDT Armor's operations in a new facility in Auburn, Alabama. Soon thereafter, the United States General Services Administration (GSA) awarded us a five-year contract for vehicle armoring, establishing a pricing schedule for armoring of GM Suburban and Toyota Land Cruiser SUVs and of GM Savana/Express passenger vans. With this contract, these armored vehicles became available for purchase directly by all federal agencies beginning December 1, 2003, and we received our first U.S. orders for vehicle armoring products during 2004.

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

Battery and Power Systems Division

We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles through our Battery and Power Systems Division. During 2005, 2004 and 2003 revenues from our Battery and Power Systems Division were approximately \$9.9 million, \$10.5 million and \$5.9 million, respectively (on a pro forma basis, assuming we had owned all components of our Battery and Power Systems Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$9.9 million, \$10.5 million and \$10.8 million, respectively).

LITHIUM BATTERIES AND CHARGING SYSTEMS FOR THE MILITARY

We sell lithium batteries and charging systems to the military through our subsidiary Epsilor Electronic Industries, Ltd., an Israeli corporation established in 1985 that we purchased early in 2004.

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.

ZINC-AIR FUEL CELLS, BATTERIES AND CHARGERS FOR THE MILITARY

We base our strategy in the field of Zinc-Air military batteries on the development and commercialization of our Zinc-Air fuel cell technology, as applied in the batteries we produce for the U.S. Army's Communications and Electronics Command (CECOM) through our subsidiary Electric Fuel Battery Corporation. 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.

Since 1998 we have received and performed a series of contracts from CECOM to develop and evaluate advanced primary Zinc-Air fuel cell packs. Pursuant to these contracts, we developed and began selling in 2002 a 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, weighs only six pounds and has approximately twice the energy capacity per pound of the U.S. Army's standard lithium-sulfur dioxide battery packs - the BA-8180/U battery.

In the second half of 2002, our five-year program with CECOM to develop a Zinc-Air battery for battlefield power culminated in the assignment of a National Stock Number and a \$2.5 million delivery order for the newly designated BA-8180/U battery. Subsequent to this initial \$2.5 million delivery order, we received additional follow-on orders from the Army.

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

A fourth generation of Zinc-Air products is being developed for applications where volume is critical, and/or where the power to energy ratio needs to be significantly higher than that of the BA-8180/U. These “Gen4” Zinc-Air products consist of an air cathode folded around a zinc electrode. Gen4 was originally developed for the Marine Corps Dragon Eye UAV, which requires up to 200 W from a battery that fits into its sleek fuselage and which weighs less than one kilogram. Along the way, it was recognized that the Gen4 design could be applied to other battery missions requiring high power as well as energy density, such as Land Warrior and Objective Force Warrior soldier systems, where up to 500 Wh of energy are required of a 24 hour battery that must be worn conformably, at minimal weight. For these systems the battery currently limits functionality, and Gen4 zinc-air may be the enabling technology. During 2004 and 2005, we were awarded \$1.65 million of congressional funds and CECOM funding for the first two phases of a three-phase BAA (Broad Agency Announcement, which is a simplified form of government solicitation for basic research and development) to develop this technology.

Our Zinc-Air batteries, rechargeable batteries and battery chargers for the military are manufactured through our Electric Fuel Battery Corporation subsidiary. In 2003, our EFB facilities were granted ISO 9001 “Top Quality Standard” certification.

ELECTRIC VEHICLE

We believe that electric buses represent a particularly important market for electric vehicles in the United States. An all-electric, full-size bus powered by the Electric Fuel system can provide to transit authorities a full day’s operating range for both heavy duty city and suburban routes in all weather conditions. We conduct our electric vehicle activities through our subsidiary Electric Fuel Ltd.

LIFEJACKET LIGHTS

In 1996, we began to produce and market lifejacket lights built with our patented magnesium-cuprous chloride batteries, which are activated by immersion in water (water-activated batteries), for the aviation and marine safety and emergency markets. Additionally, in 2004 we added two new models to our line of lifejacket light, based on lithium batteries. At present we have a product line consisting of seven lifejacket light models, five for use with marine life jackets and two for use with aviation life vests, all of which work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations. We manufacture, assemble and package all our lifejacket lights through EFL in our factory in Beit Shemesh, Israel.

Facilities and Website

Our principal executive offices have recently been relocated to 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our periodic reports, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this prospectus.

Risk Factors

We incurred significant operating losses for the years ended December 31, 2005, 2004 and 2003, and there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis, or at all. An investment in our common stock involves a high degree of risk. You should carefully consider the risk factors beginning on page 10 of this prospectus for various risks that you should consider before you purchase any shares of our common stock, including risks related to: product and technology development; the uncertainty of the market for our products; changing economic conditions; delay, cancellation or non-renewal, in whole or in part, of contracts or of purchase orders; dilution resulting from issuances of our common stock upon conversion or payment of its outstanding convertible debt, which would be increasingly dilutive if and to the extent that the market price of our stock decreases; and the ineffectiveness of our internal control over financial reporting and disclosure controls and procedures.

This Offering

Shares offered by the selling stockholders	4,360,721, including 4,062,500 shares of common stock issuable upon conversion of the Company's Senior Secured Convertible Notes and 298,221 shares of common stock issuable upon exercise of warrants.
Use of proceeds	All net proceeds from the sale of the shares of common stock will go to the stockholder who offers and sells them. We will not receive any proceeds from this offering. However, we would receive proceeds of \$2,480,006 if all of the warrants issued to the selling stockholders and outstanding as of the date of this prospectus are exercised for cash. Any such funds would be used for general corporate purposes.
Risk factors	The purchase of our common stock involves a high degree of risk. You should carefully review and consider "Risk Factors" beginning on page 10.
Nasdaq trading symbol	ARTX

RISK FACTORS

An investment in our common stock involves a high degree of risk. You should carefully consider the following risk factors and other information in this prospectus in addition to our financial statements before investing in our common stock. In addition to the following risks, there may also be risks that we do not yet know of or that we currently think are immaterial that may also impair our business operations. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment.

Business-Related Risks

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

We were incorporated in 1990 and began our operations in 1991. We have funded our operations principally from funds raised in each of the initial public offering of our common stock in February 1994; through subsequent public and private offerings of our common stock and equity and debt securities convertible or exercisable into shares of our common stock; research contracts and supply contracts; funds received under research and development grants from the Government of Israel; and sales of products that we and our subsidiaries manufacture. We have incurred significant net losses since our inception. Additionally, as of June 30, 2006, we had an accumulated deficit of approximately \$155.4 million. In an effort to reduce operating expenses and maximize available resources, we intend to consolidate certain of our subsidiaries, shift personnel and reassign responsibilities. We have also substantially reduced certain senior employee salaries during 2005, cut directors' fees, and 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.

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

Our bank and certificated indebtedness (short and long term) aggregated approximately \$16.3 million principal amount as of June 30, 2006 (not including trade payables, other account payables and accrued severance pay), of which \$10.6 million is due in 2006 (not including \$3.1 million short-term bank 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.

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

Failure to comply with the terms of our 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 the debentures and notes and the acceleration of debt under other instruments evidencing indebtedness that may contain cross-acceleration or cross-default provisions. If the indebtedness under the debentures, notes or other indebtedness were to be accelerated, there can be no assurance that our future cash flow or assets would be sufficient to repay in full such indebtedness.

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

Our ability to make payments on and to refinance 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.

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 to market our products and develop and market 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” in our Management’s Discussion and Analysis of Financial Condition and Results of Operations, and subject to the other risk factors described herein, we believe that our present cash position and anticipated cash flows from operations, lines of credit and anticipated additions to paid-in capital should be sufficient to satisfy our current estimated cash requirements through the next twelve months. 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. Moreover, the issuance by us of additional debt or equity is severely restricted by the terms of our existing indebtedness. 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.

The payment by us of our secured convertible notes in stock or the conversion of such notes by the holders could result in substantial numbers of additional shares being issued, with the number of such shares increasing if and to the extent our market price declines, diluting the ownership percentage of our existing stockholders.

In September 2005, we issued \$17.5 million in secured convertible notes due March 31, 2008. The Notes are convertible at the option of the holders at a fixed conversion price of \$14.00. We will repay the principal amount of the notes over the next two and one-half years, with the principal amount being amortized in twelve payments payable at our option in cash and/or stock, by requiring the holders to convert a portion of their Notes into shares of our common stock, provided certain conditions are met. The failure to meet such conditions could make us unable to pay our notes, causing us to default. If the price of our common stock is above \$14.00, the holders of our notes will presumably convert their notes to stock when payments are due, or before, resulting in the issuance of additional shares of our common stock.

One-twelfth of the principal amount of the Notes is payable on each of January 31, 2006, March 31, 2006, May 31, 2006, July 31, 2006, September 30, 2006, November 30, 2006, May 31, 2007, July 31, 2007, September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008. We paid the January 31, 2006 and March 31, 2006 payments in stock by requiring the holders to convert a portion of their Notes. Additionally, with the agreement of the holders of our Notes, we prepaid the payments of September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008, as well as a small portion of the payment due July 31, 2007, in stock by requiring the holders to convert a portion of their Notes, and we deferred payment of the May 31, 2006 and July 31, 2006 payment until the earlier of August 31, 2006 or five days after effectiveness of this registration statement. In the event we continue to elect to make payments of principal on our convertible notes in stock by requiring the holders to convert a portion of their Notes, either because our cash position at the time makes it necessary or we otherwise deem it advisable, the price used to determine the number of shares to be issued on conversion will be calculated using an 8% discount to the average trading price of our common stock during 17 of the 20 consecutive trading days ending two days before the payment date. Accordingly, the lower the market price of our common stock at the time at which we make payments of principal in stock, the greater the number of shares we will be obliged to issue and the greater the dilution to our existing stockholders.

In either case, the issuance of the additional shares of our common stock could adversely affect the market price of our common stock.

We can require the holder of our Notes to convert a portion of their Notes into shares of our common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. If our stock price were to decline, we might not have a sufficient number of shares of our stock registered for resale in order to continue requiring the holders to convert a portion of their Notes. As a result, we would need to file an additional registration statement with the SEC to register for resale more shares of our common stock in order to continue requiring conversion of our Notes upon principal payment becoming due. Any delay in the registration process, including through routine SEC review of our registration statement or other filings with the SEC, could result in our having to pay scheduled principal repayments on our Notes in cash, which would negatively impact our cash position and, if we do not have sufficient cash to make such payments in cash, could cause us to default on our Notes.

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

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

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

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

We may not be successful in operating new businesses.

Prior to the acquisitions of IES and MDT in 2002 and the acquisitions of FAAC and Epsilon in January 2004 and AoA in August 2004, our primary business was the marketing and sale of products based on primary and refuelable Zinc-Air fuel cell technology and advancements in battery technology for defense and security products and other military applications, electric vehicles and consumer electronics. As a result of our acquisitions, a substantial component of our business is the marketing and sale of high-tech multimedia and interactive training solutions and sophisticated lightweight materials and advanced engineering processes used to armor vehicles. These are relatively new businesses for us and our management group has limited experience operating these types of businesses. Although we have retained our acquired companies' management personnel, we cannot assure that such personnel will continue to work for us or that we will be successful in managing these new businesses. If we are unable to successfully operate these new businesses, our business, financial condition and results of operations could be materially impaired.

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

As of December 31, 2004, we had recorded goodwill of \$39.7 million. On January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement, at least annually thereafter, and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units. We performed the required annual impairment test of goodwill, based on our projections and using expected future discounted operating cash flows. As of December 31, 2005, we identified in AoA an impairment of goodwill in the amount of \$11.8 million. As of June 30, 2006, we identified in AoA an additional impairment of goodwill in the amount of \$204,000.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of 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. As of December 31, 2004, we identified an impairment of other intangible assets identified with the IES acquisition and, as a result, we recorded an impairment loss in the amount of \$320,000. As of December 31, 2005, we identified an impairment of other intangible assets identified with the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$499,000.

We will continue to assess the fair value of our goodwill annually or earlier if events occur or circumstances change that would more likely than not reduce the fair value of our goodwill below its carrying value. These events or circumstances would include a significant change in business climate, including a significant, sustained decline in an entity's market value, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business, or other factors. If we determine that significant impairment has occurred, we would be required to write off the impaired portion of goodwill. Impairment charges could have a material adverse effect on our financial condition and results.

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

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

We may consider acquisitions in the future to grow our business, and such activity could subject us to various risks.

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

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

We may not successfully integrate our prior acquisitions.

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

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

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

As a result of our acquisitions, we are currently experiencing a period of significant growth and development activity which has placed a significant strain on our personnel and resources. Our activity has resulted in increased levels of responsibility for both existing and new management personnel. Many of our management personnel have had limited or no experience in managing growing companies. We have sought to manage our current and anticipated growth through the recruitment of additional management and technical personnel and the implementation of internal systems and controls. However, our failure to manage growth effectively could adversely affect our results of operations.

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

Many of the customers of IES, FAAC and AoA to date have been in the public sector of the U.S., including the federal, state and local governments, and in the public sectors of a number of other countries, and most of MDT's customers have been in the public sector in Israel, in particular the Ministry of Defense. Additionally, all of EFB's sales to date of battery products for the military and defense sectors have been in the public sector in the United States. A significant decrease in the overall level or allocation of defense or law enforcement spending in the U.S. or other countries could reduce our revenues and have a material adverse effect on our future results of operations and financial condition.

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.

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.

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.

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

Some of our contracts are fixed-price contracts under which we bear the risk of any cost overruns. Our profits are adversely affected if our costs under these contracts exceed the assumptions that we used in bidding for the contract. Often, we are required to fix the price for a contract before we finalize the project specifications, which increases the risk that we will mis-price these contracts. The complexity of many of our engagements makes accurately estimating our time and resources more difficult. 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 of several of our significant contracts or nonrenewal of several of our significant contracts, could result in significant revenue shortfalls.

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

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

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

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

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

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

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

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

Our fields of business are highly competitive.

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

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

Our battery technology competes with other battery technologies, as well as other Zinc-Air technologies. The competition in this area of our business consists of development stage companies, major international companies and consortia of such companies, including battery manufacturers, automobile manufacturers, energy production and transportation companies, consumer goods companies and defense contractors.

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

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

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

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

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

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

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

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

We are highly dependent on the president of our FAAC subsidiary and the general managers of our MDT and Epsilor subsidiaries, and the loss of the services of one or more of these persons could adversely affect us. We are especially dependent on the services of our Chairman and Chief Executive Officer, Robert S. Ehrlich, and our President and Chief Operating Officer, Steven Esses. The loss of either Mr. Ehrlich or Mr. Esses could have a material adverse effect on us. We are party to an employment agreement with Mr. Ehrlich, which agreement expires at the end of 2007, and an employment agreement with Mr. Esses, which agreement expires at the end of 2006. We do not have key-man life insurance on either Mr. Ehrlich or Mr. Esses.

Payment of severance or retirement benefits earlier than anticipated could strain our cash flow.

Our Chairman and Chief Executive Officer, Robert S. Ehrlich, and our President and Chief Operating Officer, Steven Esses, both have employment agreements that provide for substantial severance payments and retirement benefits. We are required to fund a certain portion of these payments according to a predetermined schedule. Should Mr. Ehrlich or Mr. Esses leave our employ under circumstances entitling them to severance or retirement benefits, or become disabled or die, before we have funded these payments, the need to pay these severance or retirement benefits ahead of their anticipated schedule could put a strain on our cash flow and have a material adverse effect on our financial condition.

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 2005, 2004 and 2003, without taking account of revenues derived from discontinued operations, 21%, 19% and 42%, 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.

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

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to include an internal control report of management in our Annual Report on Form 10-K. Our management acknowledges its responsibility for internal controls over financial reporting and seeks to continually improve those controls. In addition, in order to achieve compliance with Section 404 within the prescribed period, we have been engaged in a process to document and evaluate our internal controls over financial reporting. In this regard, management has dedicated internal resources, engaged outside consultants and adopted a work plan to (i) assess and document the adequacy of internal control over financial reporting, (ii) take steps to improve control processes where appropriate, (iii) validate through testing that controls are functioning as documented and (iv) implement a continuous reporting and improvement process for internal control over financial reporting. We believe our process for documenting, evaluating and monitoring our internal control over financial reporting is consistent with the objectives of Section 404 of Sarbanes-Oxley.

We have, with our auditors' concurrence, identified a material weakness under standards established by the Public Company Accounting Oversight Board (PCAOB) related to our FAAC subsidiary. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our auditors have reported to us that at December 31, 2005, we had a material weakness for inadequate controls related to our FAAC subsidiary, in that we did not maintain effective controls over the monitoring, review and approval of revenue recognition calculations at FAAC.

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

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

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

Market-Related Risks

The price of our common stock is volatile.

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

- 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.

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 (formerly known as the Nasdaq National Market), on which our stock is currently listed, and the Nasdaq Capital Market (formerly known as the Nasdaq SmallCap Market)) is the maintenance of a \$1.00 bid price. Our stock price was below \$1.00 between August 15, 2005 and June 20, 2006; however, on June 21, 2006, we effected a one-for-fourteen reverse stock split, which brought the bid price of our common stock back over \$1.00. If our bid price were to go and remain below \$1.00 for 30 consecutive business days, Nasdaq could notify us of our failure to meet the continued listing standards, after which we would have 180 calendar days to correct such failure or be delisted from the Nasdaq Global Market. In addition, we may be unable to satisfy the other continued listing requirements.

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. 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.

Additionally, delisting from the Nasdaq Stock Market would constitute an event of default under our debentures due in September 2006, which could result in acceleration of debt under other instruments evidencing other indebtedness that may contain cross-acceleration or cross-default provisions, even if the delisting were not an event of default under those other instruments.

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

Sales of a substantial number of shares of common stock into the public market, or the perception that those sales could occur, could adversely affect our stock price or could impair our ability to obtain capital through an offering of equity securities. As of June 30, 2006, we had 8,468,957 shares of common stock issued and outstanding. Of these shares, most are freely transferable without restriction under the Securities Act of 1933 or pursuant to effective resale registration statements, and a substantial portion of the remaining shares may be sold subject to the volume restrictions, manner-of-sale provisions and other conditions of Rule 144 under the Securities Act of 1933.

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

As of June 30, 2006, there were outstanding warrants to purchase a total of 1,068,924 shares of our common stock at a weighted average exercise price of \$14.27 per share, options to purchase a total of 616,511 shares of our common stock at a weighted average exercise price of \$11.00 per share, of which 589,490 were vested, at a weighted average exercise price of \$10.68 per share, and outstanding debentures and notes convertible into a total of 827,909 shares of our common stock at a weighted average conversion price of \$15.68 per share. Holders of our options, warrants and convertible debt will probably exercise or convert them only at a time when the price of our common stock is higher than their respective exercise or conversion prices. Accordingly, we may be required to issue shares of our common stock at a price substantially lower than the market price of our stock. This could adversely affect our stock price. In addition, if and when these shares are issued, the percentage of our common stock that existing stockholders own will be diluted.

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

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

- 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.

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

Israel-Related Risks

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

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

Historically, Arab states have boycotted any direct trade with Israel and to varying degrees have imposed a secondary boycott on any company carrying on trade with or doing business in Israel. Although in October 1994, the states comprising the Gulf Cooperation Council (Saudi Arabia, the United Arab Emirates, Kuwait, Dubai, Bahrain and Oman) announced that they would no longer adhere to the secondary boycott against Israel, and Israel has entered into certain agreements with Egypt, Jordan, the Palestine Liberation Organization and the Palestinian Authority, Israel has not entered into any peace arrangement with Syria or Lebanon. Moreover, since September 2000, there has been a significant deterioration in Israel's relationship with the Palestinian Authority, and a significant increase in terror and violence. Israel recently withdrew unilaterally from the Gaza Strip and certain areas in northern Samaria. It is unclear what the long-term effects of such disengagement plan will be. Efforts to resolve the problem have failed to result in an agreeable solution. The election of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council has created additional unrest and uncertainty. Recently, there has been a sharp increase in hostilities along Israel's northern border with Lebanon and to a lesser extent in the Gaza Strip. There can be no assurance that such hostilities will not intensify. Continued hostilities between the Palestinian community and Israel and any failure to settle the conflict may have a material adverse effect on our business and us. Moreover, the current political and security situation in the region has already had an adverse effect on the economy of Israel, which in turn may have an adverse effect on us.

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

We are organized under the laws of the State of Delaware and will be subject to service of process in the United States. However, approximately 22% of our assets are located outside the United States. In addition, two of our directors and most of our executive officers are residents of Israel and a portion of the assets of such directors and executive officers are located outside the United States.

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 2005, the inflation adjusted NIS depreciated against the dollar.

Some of our agreements are governed by Israeli law.

Israeli law governs some of our agreements, such as our lease agreements on our subsidiaries' premises in Israel, and the agreements pursuant to which we purchased IES, MDT and Epsilor. While Israeli law differs in certain respects from American law, we do not believe that these differences materially adversely affect our rights or remedies under these agreements.

INFORMATION REGARDING FORWARD-LOOKING STATEMENTS

When used in this prospectus, the words “expects,” “anticipates,” “estimates” and similar expressions identify forward-looking statements. These statements are “forward-looking” statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements, which include statements under the caption “Risk Factors” and elsewhere in this prospectus, refer to product and technology development; the uncertainty of the market for our products; changing economic conditions; delay, cancellation or non-renewal, in whole or in part, of contracts or of purchase orders; our ability to remain listed on the Nasdaq Stock Market in accordance with the Nasdaq’s \$1.00 minimum bid price and other continued listing standards; dilution resulting from issuances of our common stock upon conversion or payment of our outstanding convertible debt, which would be increasingly dilutive if and to the extent that the market price of our stock decreases. The forward-looking statements also include our expectations concerning factors affecting the markets for our products.

These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from the results that we anticipate. These risks and uncertainties include, but are not limited to, those risks discussed in this prospectus and in the documents incorporated by reference in this prospectus.

All such forward-looking statements are current only as of the date on which such statements were made. We assume no obligation to update these forward-looking statements or to update the reasons actual results could differ materially from the results anticipated in the forward-looking statements.

You should rely only on the information in this prospectus. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely upon it. You should assume that the information in this prospectus was accurate on the date of the front cover of this prospectus only. Our business, financial condition, results of operations and prospects may have changed since that date.

ABOUT THE OFFERING

We are registering the resale of our common stock by the selling stockholders. The selling stockholders and the specific number of shares that they may resell through this prospectus are listed on page 26. The shares offered for resale by this prospectus consist of the following:

- 4,062,500 shares of common stock that may be acquired upon the conversion of currently outstanding convertible notes; and
- 298,221 shares of common stock that may be acquired upon the exercise of currently outstanding warrants.

The above securities were issued in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act as transactions by an issuer not involving a public offering.

Shares Underlying Convertible Notes

On September 29, 2005, we entered into a Securities Purchase Agreement with the selling stockholders pursuant to which we raised an aggregate of \$17,500,000 before issuance and related costs, and issued senior secured convertible notes in the aggregate principal amount of \$17,500,000 and warrants to purchase up to 375,000 shares of our common stock at an exercise price of \$15.40 per share.

The notes are convertible at any time at the option of the investors into shares of our common stock at a conversion price of \$14.00 per share. The last installment of principal is due on March 31, 2008. The notes bear interest at a rate of the applicable six-month LIBOR rate plus 6% per annum, subject to periodic adjustment, provided that the interest rate shall not be less than 10% per annum or greater than 12.5% per annum other than upon an event of default as provided in the notes. The first interest payment on the notes was due on December 31, 2005, and thereafter accrued interest is payable quarterly in arrears. We purchased a \$2,625,000 letter of credit to secure our interest payments and certain other obligations under the notes using a portion of the net proceeds from the offering.

The notes have a term of two and one-half years, and one-twelfth of the principal amount is payable on each of January 31, 2006, March 31, 2006, May 31, 2006, July 31, 2006, September 30, 2006, November 30, 2006, May 31, 2007, July 31, 2007, September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008. We are current with these payments and in compliance with the conditions described below, having paid the January 31, 2006 and March 31, 2006 payments, and having prepaid the payments of September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008, as well as a small portion of the payment due July 31, 2007, and having deferred payment of the May 31, 2006 and July 31, 2006 payment until the earlier of August 31, 2006 or five days after effectiveness of this registration statement. We have the option to pay principal in cash or, subject to the satisfaction of the conditions described below, in shares of our common stock by requiring the holders to convert a portion of their notes, or a combination thereof. In the event we elect to require the holders to convert a portion of their notes upon a principal payment, the shares of our common stock to be issued upon conversion must have been registered for resale and the price used to determine the number of shares to be issued will be based on 92% of the arithmetic average trading price of our common stock during 17 of the 20 consecutive trading days ending two days before the payment date. In order to have a sufficient number of registered shares of common stock to facilitate payments of principal installments in shares of our common stock, in December 2005 we registered 130% of the number of shares issuable upon conversion of the notes. However, because the price of our stock has been lower than we had anticipated when we filed the 2005 registration statement, and because of the prepayment of the payments due September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008, as well as a small portion of the payment due July 31, 2007, we no longer have shares available for issuance under the 2005 registration statement and will not be able to require conversion into shares of our common stock in respect of future payments unless we register for resale additional shares of our common stock. Accordingly, we deem it prudent to register an additional 325% of the number of shares originally issuable upon conversion of the notes based upon a conversion price of \$14.00 per share in this registration statement.

The conditions referred to above require that, during the period beginning 15 trading days before the date we are required to provide notice of our election to require conversion of a portion of their notes until the date of the applicable principal payment, interest payment or mandatory conversion, (1) this registration statement must be effective or all shares of our common stock must be eligible for sale without restriction and without the need for registration, (2) our common stock must be designated for quotation on an "Eligible Market" (which term includes the Nasdaq Global Market, the Nasdaq Capital Market and the OTC Bulletin Board) and shall not have been suspended from trading nor shall suspension have been threatened or pending (other than in connection with failure to satisfy Nasdaq's \$1.00 minimum bid price listing standard), (3) we must have delivered shares to the holders on a timely basis in connection with any conversion of the notes or any exercise of the warrants, (4) we must be able to issue the applicable shares in full without exceeding the volume limitations set forth in the notes and the warrants, (5) we must have timely made any payments that became due and payable under the notes, (6) there must not have been a public announcement of a pending or intended fundamental transaction which has not been abandoned, (7) there must not have occurred an event of default or an event that could constitute an event of default under the notes, (8) we must not have knowledge of any fact that would cause the shares not to be eligible for resale, and (9) we must not be in breach of any provision, covenant, representation or warranty of any agreement executed in connection with the transaction to the extent that such breach would have a material adverse effect.

Under the terms of the Securities Purchase Agreement, we have granted the investors (i) a second position security interest in the stock of MDT Armor Corporation, IES Interactive Training, Inc. and M.D.T. Protective Industries, Ltd. (junior to the security interest of the holders of our 8% secured convertible debentures due September 30, 2006) and in the assets of FAAC Incorporated (junior to the security interest of a bank that extends to FAAC Corporation a \$5 million line of credit) and in any stock that we acquire in future Acquisitions (as defined in the Securities Purchase Agreement) and (ii) a first position security interest in the assets of all of our other active United States subsidiaries, all pursuant to the terms of separate security agreements. Our active United States subsidiaries are also acting as guarantors of our obligations under the notes.

Shares Underlying Warrants

In February and March 2006, we amended certain of our existing warrants to lower the exercise price in exchange for immediate exercise and the granting of a lower number of new warrants (298,221 warrants, which was 40% of the number of warrants that were exercised) to purchase shares of our common stock at a price of \$8.316 per share. We are registering the shares underlying these warrants for resale.

USE OF PROCEEDS

All net proceeds from the sale of the shares of common stock will go to the stockholder who offers and sells them. We will not receive any proceeds from this offering. However, we would receive proceeds of \$2,480,006 if all of the warrants being registered by this prospectus that are issued to the selling stockholders and outstanding as of the date of this prospectus are exercised for cash. Any such funds would be used for general corporate purposes.

SELLING STOCKHOLDERS

The shares of common stock being offered by the selling stockholders are issuable upon conversion of the convertible notes or exercise of the warrants. For additional information regarding the issuance of those convertible notes and warrants, see "About the Offering," above. We are registering the shares of common stock in order to permit the selling stockholders to offer the shares for resale from time to time. Except for the ownership of the (i) convertible notes issued pursuant to the Securities Purchase Agreement and the warrants being registered hereby, (ii) warrants issued pursuant to the Securities Purchase Agreement that have been previously registered, (iii) shares of common stock issued pursuant to the Securities Purchase Agreements dated July 15, 2004 and warrants issued in connection therewith, and (iv) convertible debentures and warrants issued pursuant to the Securities Purchase Agreement dated September 30, 2003, the selling stockholders have not had any material relationship with us within the past three years.

The table below lists the selling stockholders and other information regarding the beneficial ownership of the shares of common stock by each of the selling stockholders. The first column lists the selling stockholder. The second column lists the number of shares of common stock outstanding and beneficially owned by each selling stockholder as of August 18, 2006, without taking account of shares that the stockholder has the right to acquire within 60 days. The third column lists all shares of common stock beneficially owned by the selling stockholder, including all shares being registered hereby, assuming conversion of all convertible notes (at an assumed rate of conversion based solely on the number of conversion shares being registered hereby) and exercise of all warrants held by the selling stockholders on that date, without regard to any limitations on conversions or exercise. The fourth column lists the shares of common stock being offered by this prospectus by the selling stockholders, and the fifth column lists the percentage of our common stock represented by the fourth column..

This prospectus generally covers the resale of up to an additional 325% of the number of shares of common stock originally issuable upon conversion of the convertible notes. Because the number of shares issuable by us if we elect to make principal payments by requiring conversion of a portion of the notes into shares of our common stock will be based on the market price of our stock at the time of such election, the number of shares that will actually be issued may be more or fewer than the number of shares being offered by this prospectus. The fourth column assumes the sale of all of the shares offered by the selling stockholders pursuant to this prospectus.

Under the terms of the convertible notes and the replacement warrants, a selling stockholder may not convert, and we may not be able to require the conversion of, the convertible notes or exercise the warrants to the extent such conversion or exercise would cause such selling stockholder, together with its affiliates, to beneficially own a number of shares of common stock which would exceed 4.99% of our then outstanding shares of common stock following such conversion or exercise, excluding for purposes of such determination shares of common stock issuable upon conversion of the convertible notes which have not been converted or upon exercise of the warrants which have not been exercised. The number of shares in the second column and the percentage in the fourth column do not reflect this limitation. The selling stockholders may sell all, some or none of their shares in this offering. See “Plan of Distribution.”

Beneficial ownership is determined in accordance with Rule 13d-3 promulgated by the Securities and Exchange Commission, and generally includes voting or investment power with respect to securities. Except as indicated in the footnotes to the table, we believe each holder possesses sole voting and investment power with respect to all of the shares of common stock beneficially owned by that holder. In computing the number of shares beneficially owned by a holder and the percentage ownership of that holder, shares of common stock subject to options or warrants or underlying debentures held by that holder that are currently exercisable or convertible or are exercisable or convertible within 60 days after the date of the table are deemed outstanding. Those shares, however, are not deemed outstanding for the purpose of computing the percentage ownership of any other person.

Name of Selling Stockholder	Number of Outstanding Shares Beneficially Owned Prior to Offering	Number of Shares Beneficially Owned Prior to Offering Including Shares Potentially Issuable on Exercise of Warrants and Conversion of Convertible Debt (1)	Maximum Number of Shares to be Sold Pursuant to this Prospectus	Shares Beneficially Owned After Offering Including Shares Potentially Issuable on Exercise of Warrants and Conversion of Convertible Debt (2)	
				Number	Percent
Smithfield Fiduciary LLC ⁽³⁾	207,504	2,478,887 ⁽⁴⁾	1,996,505	482,382	5.5%
Omicron Master Trust ⁽³⁾	152,900	245,360 ⁽⁵⁾	41,218	204,142	2.4%
Portside Growth and Opportunity Fund ⁽³⁾	0	1,282,659 ⁽⁶⁾	1,176,758	105,901	1.2%
Iroquois Master Fund Ltd. ⁽³⁾	41,185	548,328 ⁽⁷⁾	464,285	84,043	*
Cranshire Capital L.P. ⁽³⁾	127,970	550,812 ⁽⁸⁾	383,309	167,503	2.0%
Mainfield Enterprises Inc. ⁽³⁾	0	94,925 ⁽⁹⁾	41,273	53,652	*
Rockmore Investment Master Fund Ltd. ⁽³⁾	65,361	350,198 ⁽¹⁰⁾	257,373	92,825	1.1%

* Less than 1%.

⁽¹⁾ Includes all shares being registered hereby, and assumes (i) conversion of all convertible notes at an assumed rate of conversion based solely on the number of conversion shares being registered hereby, and (ii) exercise of all warrants held by the selling stockholders, without regard to any limitations on conversions or exercise. Also assumes that the selling stockholders acquire no additional shares of common stock before completion of this offering. For purposes of determining beneficial ownership of our common stock, owners of options, warrants and other convertible securities exercisable or convertible within sixty days are considered to be the beneficial owners of the shares of common stock for which such securities are exercisable or convertible.

⁽²⁾ Assumes that all of the shares offered by the selling stockholders under this prospectus are sold. Percentage ownership is computed in accordance with Rule 13d-3 promulgated by the Securities and Exchange Commission, 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 such derivative securities for shares of common stock, and is based on 8,468,957 shares issued and outstanding as of August 18, 2006.

- ⁽³⁾ The terms of the notes and warrants whose underlying shares of common stock are included for resale under this prospectus prohibit conversion of the convertible notes and exercise of the warrants to the extent that conversion of the convertible notes and exercise of the warrants would result in the holder, together with its affiliates, beneficially owning in excess of 4.999% of our outstanding shares of common stock.

- (4) Consists of (i) 1,857,143 shares of common stock, which is approximately 325% of the 571,429 shares originally issuable upon conversion of convertible notes issued in September 2005 (based on the original principal amount outstanding), being registered hereby, of which 275,410 shares are issuable based on the \$14.00 conversion price of the remaining convertible notes, (ii) 139,362 shares of common stock issuable upon exercise of the warrants being registered hereby, (iii) 171,429 shares of common stock issuable upon exercise of the warrants issued in connection with the convertible notes, (iv) 103,449 shares of common stock issuable upon conversion of certain convertible debentures, and (v) 207,504 shares of common stock. Highbridge Capital Management, LLC (“Highbridge”) is the trading manager of Smithfield Fiduciary LLC (“Smithfield”) and consequently has voting control and investment discretion over the securities held by Smithfield. Messrs. Glenn Dubin and Henry Swieca control Highbridge. Each of Highbridge and Messrs. Dubin and Swieca disclaims beneficial ownership of the securities held by Smithfield.
- (5) Consists of (i) 41,218 shares of common stock issuable upon exercise of the warrants being registered hereby, (ii) 51,242 shares of common stock issuable upon exercise of the warrants issued in connection with the convertible notes, and (iii) 152,900 shares of common stock. Omicron Capital, L.P., a Delaware limited partnership (“Omicron Capital”), serves as investment manager to Omicron Master Trust, a trust formed under the laws of Bermuda (“Omicron”), Omicron Capital, Inc., a Delaware corporation (“OCI”), serves as general partner of Omicron Capital, and Winchester Global Trust Company Limited (“Winchester”) serves as the trustee of Omicron. By reason of such relationships, Omicron Capital and OCI may be deemed to share dispositive power over the securities owned by Omicron, and Winchester may be deemed to share voting and dispositive power over the securities owned by Omicron. Omicron Capital, OCI and Winchester disclaim beneficial ownership of such securities. Omicron Capital has delegated authority from the board of directors of Winchester regarding the portfolio management decisions with respect to the securities owned by Omicron and, as of April 21, 2003, Mr. Olivier H. Morali and Mr. Bruce T. Bernstein, officers of OCI, have delegated authority from the board of directors of OCI regarding the portfolio management decisions of Omicron Capital with respect to the securities owned by Omicron. By reason of such delegated authority, Messrs. Morali and Bernstein may be deemed to share dispositive power over the securities owned by Omicron. Messrs. Morali and Bernstein disclaim beneficial ownership of such securities and neither of such persons has any legal right to maintain such delegated authority. No other person has sole or shared voting or dispositive power with respect to the securities being offered by Omicron, as those terms are used for purposes under Regulation 13D-G of the Securities Exchange Act of 1934, as amended. Omicron and Winchester are not “affiliates” of one another, as that term is used for purposes of the Securities Exchange Act of 1934, as amended, or of any other person named in this prospectus as a selling stockholder. No person or “group” (as that term is used in Section 13(d) of the Securities Exchange Act of 1934, as amended, or the SEC’s Regulation 13D-G) controls Omicron and Winchester.
- (6) Consists of (i) 1,135,485 shares of common stock, which is 325% of the 349,380 shares originally issuable upon conversion of convertible notes issued in September 2005 based on the original principal amount outstanding, being registered hereby, of which 168,390 shares are issuable based on the \$14.00 conversion price of the remaining convertible notes, (ii) 41,273 shares of common stock issuable upon exercise of the warrants being registered hereby, (iii) 53,572 shares of common stock issuable upon exercise of the warrants issued in connection with the convertible notes, (iv) 52,329 shares of common stock issuable upon conversion of certain convertible debentures. Ramius Capital Group, LLC is the investment adviser of Portside Growth and Opportunity Fund and consequently has voting control and investment discretion over securities held by Portside. Ramius Capital disclaims beneficial ownership of the securities held by Portside. Peter A. Cohen, Morgan B. Stark, Thomas W. Strauss and Jeffrey M. Solomon are the sole managing members of C4S & Co., LLC, the sole managing member of Ramius Capital. As a result, Messrs. Cohen, Stark, Strauss and Solomon may be considered beneficial owners of any securities deemed to be beneficially owned by Ramius Capital. Each of Messrs. Cohen, Stark, Strauss and Solomon disclaims beneficial ownership of the securities held by Portside.
- (7) Consists of (i) 464,285 shares of common stock, which is approximately 325% of the 142,857 shares originally issuable upon conversion of convertible notes issued in September 2005 based on the original principal amount outstanding, being registered hereby, of which 68,853 shares are issuable based on the \$14.00 conversion price of the remaining convertible notes, (ii) 42,858 shares of common stock issuable upon exercise of the warrants issued in connection with the convertible notes, and (iii) 41,185 shares of common stock. Joshua Silverman has voting control and investment discretion over the securities held by this selling stockholder. Mr. Silverman disclaims beneficial ownership of the securities held by Iroquois Master Fund Ltd.
- (8) Consists of (i) 348,214 shares of common stock, which is approximately 325% of the 107,143 shares originally issuable upon conversion of convertible notes issued in September 2005 based on the original principal amount outstanding, being registered hereby, of which 51,640 shares are issuable based on the \$14.00 conversion price of the remaining convertible notes, (ii) 35,095 shares of common stock issuable upon exercise of the warrants being registered hereby, (iii) 32,143 shares of common stock issuable upon exercise of the warrants issued in connection with the convertible notes, (iv) 7,390 shares of common stock issuable upon conversion of certain convertible debentures, and (v) 127,970 shares of common stock. Mitchell P. Kopin, President of Downsvie Capital Inc., the General Partner of Cranshire Capital L.P., has the right to vote and/or dispose of the shares held by this selling stockholder. Mr. Kopin and

Downsview Capital, Inc. both disclaim beneficial ownership of these securities.

- (9) Consists of (i) 41,273 shares of common stock issuable upon exercise of the warrants being registered hereby, and (ii) 53,652 shares of common stock issuable upon conversion of certain convertible debentures. Pursuant to an investment management agreement, Avi Vigder has voting and dispositive control over the Shares held by Mainfield Enterprises, Inc. Avi Vigder disclaims beneficial ownership of said shares.
- (10) Consists of (i) 257,373 shares of common stock, which is approximately 325% of the 79,192 shares originally issuable upon conversion of convertible notes issued in September 2005 based on the original principal amount outstanding, being registered hereby, of which 38,168 shares are issuable based on the \$14.00 conversion price of the remaining convertible notes, (ii) 23,758 shares of common stock issuable upon exercise of the warrants issued in connection with the convertible notes, (iii) 3,706 shares of common stock issuable upon conversion of certain convertible debentures, debentures, all of which securities it acquired in transfers from Omicron Master Trust in July 2006, and (iv) 65,361 shares of common stock. Rockmore Capital, LLC (“Rockmore Capital”) and Rockmore Partners, LLC (“Rockmore Partners”), each a limited liability company formed under the laws of the State of Delaware, serve as the investment manager and general partner, respectively, to Rockmore Investments (US) LP, a Delaware limited partnership, which invests all of its assets through Rockmore Investment Master Fund Ltd., an exempted company formed under the laws of Bermuda (“Rockmore Master Fund”). By reason of such relationships, Rockmore Capital and Rockmore Partners may be deemed to share dispositive power over the shares of our common stock owned by Rockmore Master Fund. Rockmore Capital and Rockmore Partners disclaim beneficial ownership of such shares of our common stock. Rockmore Partners has delegated authority to Rockmore Capital regarding the portfolio management decisions with respect to the shares of common stock owned by Rockmore Master Fund and, as of August 18, 2006, Mr. Bruce T. Bernstein and Mr. Brian Daly, as officers of Rockmore Capital, are responsible for the portfolio management decisions of the shares of common stock owned by Rockmore Master Fund. By reason of such authority, Messrs. Bernstein and Daly may be deemed to share dispositive power over the shares of our common stock owned by Rockmore Master Fund. Messrs. Bernstein and Daly disclaim beneficial ownership of such shares of our common stock and neither of such persons has any legal right to maintain such authority. No other person has sole or shared voting or dispositive power with respect to the shares of our common stock as those terms are used for purposes under Regulation 13D-G of the Securities Exchange Act of 1934, as amended. No person or “group” (as that term is used in Section 13(d) of the Securities Exchange Act of 1934, as amended, or the SEC’s Regulation 13D-G) controls Rockmore Master Fund.

PLAN OF DISTRIBUTION

We are registering the shares of common stock issuable upon conversion of the convertible notes and exercise of the warrants to permit the resale of these shares of common stock by the holders of the convertible notes and warrants from time to time after the date of this prospectus. We will not receive any of the proceeds from the sale by the selling stockholders of the shares of common stock. We will bear all fees and expenses incident to our obligation to register the shares of common stock.

The selling stockholders may sell all or a portion of the shares of common stock beneficially owned by them and offered hereby from time to time directly or through one or more underwriters, broker-dealers or agents. If the shares of common stock are sold through underwriters or broker-dealers, the selling stockholders will be responsible for underwriting discounts or commissions or agent’s commissions. The shares of common stock may be sold in one or more transactions at fixed prices, at prevailing market prices at the time of the sale, at varying prices determined at the time of sale, or at negotiated prices. These sales may be effected in transactions, which may involve crosses or block transactions,

- on any national securities exchange or quotation service on which the securities may be listed or quoted at the time of sale;
- in the over-the-counter market;

- in transactions otherwise than on these exchanges or systems or in the over-the-counter market;
- through the writing of options, whether such options are listed on an options exchange or otherwise;
- ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;
- block trades in which the broker-dealer will attempt to sell the shares as agent but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker-dealer as principal and resale by the broker-dealer for its account;
- an exchange distribution in accordance with the rules of the applicable exchange;
- privately negotiated transactions;
- short sales;
- sales pursuant to Rule 144;
- broker-dealers may agree with the selling securityholders to sell a specified number of such shares at a stipulated price per share;
- a combination of any such methods of sale; and
- any other method permitted pursuant to applicable law.

If the selling stockholders effect such transactions by selling shares of common stock to or through underwriters, broker-dealers or agents, such underwriters, broker-dealers or agents may receive commissions in the form of discounts, concessions or commissions from the selling stockholders or commissions from purchasers of the shares of common stock for whom they may act as agent or to whom they may sell as principal (which discounts, concessions or commissions as to particular underwriters, broker-dealers or agents may be in excess of those customary in the types of transactions involved). In connection with sales of the shares of common stock or otherwise, the selling stockholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the shares of common stock in the course of hedging in positions they assume. The selling stockholders may also sell shares of common stock short and deliver shares of common stock covered by this prospectus to close out short positions and to return borrowed shares in connection with such short sales. The selling stockholders may also loan or pledge shares of common stock to broker-dealers that in turn may sell such shares.

The selling stockholders may, from time to time, pledge or grant a security interest in some or all of the convertible notes or shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock from time to time pursuant to this prospectus or any amendment to this prospectus under Rule 424 (b)(3) or other applicable provision of the Securities Act of 1933, as amended, amending, if necessary, the list of selling stockholders to include the pledgee, transferee or other successors in interest as selling stockholders under this prospectus. The selling stockholders also may transfer and donate the shares of common stock in other circumstances in which case the transferees, donees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus. The selling stockholders may also enter into option or other transactions with broker-dealers or other financial institutions or the creation of one or more derivative securities which require the delivery to such broker-dealer or other financial institution of shares offered by this prospectus, which shares such broker-dealer or other financial institution may resell pursuant to this prospectus (as supplemented or amended to reflect such transaction).

The selling stockholders and any broker-dealer participating in the distribution of the shares of common stock may be deemed to be “underwriters” within the meaning of the Securities Act, and any commission paid, or any discounts or concessions allowed to, any such broker-dealer may be deemed to be underwriting commissions or discounts under the Securities Act. At the time a particular offering of the shares of common stock is made, a prospectus supplement, if required, will be distributed which will set forth the aggregate amount of shares of common stock being offered and the terms of the offering, including the name or names of any broker-dealers or agents, any discounts, commissions and other terms constituting compensation from the selling stockholders and any discounts, commissions or concessions allowed or reallocated or paid to broker-dealers.

Under the securities laws of some states, the shares of common stock may be sold in such states only through registered or licensed brokers or dealers. In addition, in some states the shares of common stock may not be sold unless such shares have been registered or qualified for sale in such state or an exemption from registration or qualification is available and is complied with.

There can be no assurance that any selling stockholder will sell any or all of the shares of common stock registered pursuant to the shelf registration statement, of which this prospectus forms a part.

The selling stockholders and any other person participating in such distribution may be subject to applicable provisions of the Securities Exchange Act of 1934, as amended, and the rules and regulations thereunder, including, without limitation, Regulation M of the Securities Exchange Act of 1934, which may limit the timing of purchases and sales of any of the shares of common stock by the selling stockholders and any other participating person. Regulation M may also restrict the ability of any person engaged in the distribution of the shares of common stock to engage in market-making activities with respect to the shares of common stock. All of the foregoing may affect the marketability of the shares of common stock and the ability of any person or entity to engage in market-making activities with respect to the shares of common stock.

We will pay all expenses of the registration of the shares of common stock pursuant to the registration rights agreement, estimated to be \$20,000 in total, including, without limitation, Securities and Exchange Commission filing fees and expenses of compliance with state securities or “blue sky” laws; provided, however, that a selling stockholder will pay all underwriting discounts and selling commissions, if any. We will indemnify the selling stockholders against liabilities, including some liabilities under the Securities Act, in accordance with the registration rights agreements, or the selling stockholders will be entitled to contribution. We may be indemnified by the selling stockholders against civil liabilities, including liabilities under the Securities Act, that may arise from any written information furnished to us by the selling stockholder specifically for use in this prospectus, in accordance with the related registration rights agreements, or we may be entitled to contribution.

Once sold under the shelf registration statement, of which this prospectus forms a part, the shares of common stock will be freely tradable in the hands of persons other than our affiliates.

Our common stock is currently traded on the Nasdaq Global Market under the symbol “ARTX.”

DESCRIPTION OF CAPITAL STOCK

General

Our authorized capital stock consists of 250,000,000 shares of common stock par value \$0.01 per share, and 1,000,000 shares of preferred stock, par value \$0.01 per share. As of June 30, 2006, 8,468,957 shares of common stock were issued and outstanding, 39,666 shares of common stock were held as treasury shares, and no shares of preferred stock were issued and outstanding.

The additional shares of our authorized stock available for issuance might be issued at times and under circumstances so as to have a dilutive effect on earnings per share and on the equity ownership of the holders of our common stock. The ability of our board of directors to issue additional shares of stock could enhance the board’s ability to negotiate on behalf of the stockholders in a takeover situation but could also be used by the board to make a change-in-control more difficult, thereby denying stockholders the potential to sell their shares at a premium and entrenching current management. The following description is a summary of the material provisions of our capital stock. You should refer to our amended and restated certificate of incorporation, as amended, and bylaws for additional information.

Common Stock

The holders of common stock are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders. Except as required under Delaware law or the rules of the Nasdaq Global Market, the rights of stockholders may not be modified otherwise than by a vote of a majority or more of the shares outstanding. Subject to preferences that may be applicable to any outstanding shares of preferred stock, the holders of common stock are entitled to receive ratably any dividends as may be declared by the board of directors out of funds legally available for the payment of dividends. In the event of our liquidation, dissolution or winding up, the holders of common stock are entitled to share ratably in all assets, subject to prior distribution rights of the preferred stock, if any, then outstanding. Holders of common stock have no preemptive rights or rights to convert their common stock into any other securities. There are no redemption or sinking fund provisions applicable to the common stock. All outstanding shares of common stock are fully paid and non-assessable.

Preferred Stock

Our board of directors has the authority, within the limitations and restrictions stated in our amended and restated certificate of incorporation and without stockholder approval, to provide by resolution for the issuance of shares of preferred stock, and to fix the rights, preferences, privileges and restrictions thereof, including dividend rights, conversion rights, voting rights, terms of redemption, liquidation preference and the number of shares constituting any series of the designation of such series. The issuance of preferred stock could have the effect of decreasing the market price of the common stock, impeding or delaying a possible takeover and adversely affecting the voting and other rights of the holders of our common stock. At present, we have no plans to issue preferred stock.

Certain Charter Provisions

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.

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.

DESCRIPTION OF COMMON STOCK WARRANTS

Each warrant, the underlying shares of common stock of which are being registered pursuant to this registration statement, entitles the holder to purchase, at an exercise price of \$8.316 per share, one share of our common stock. Subject to the provision contained in the warrant restricting exercise of the warrant and described under “Selling Stockholders,” the warrant is exercisable by the holder at any time and will expire on March 31, 2008.

The warrants are generally exercisable by the holder, in whole or in part, by surrender to us of the warrant, together with a completed exercise agreement, and payment by the holder of the aggregate exercise price in cash, or, in limited circumstances, by effecting a cashless exercise. Upon any exercise of the warrant, we will forward to the holder, as soon as practicable, but not exceeding three business days after proper exercise, a certificate representing the number of shares of common stock purchased upon such exercise. If less than all of the shares represented by the warrant are purchased, we will also deliver to the holder a new warrant representing the right to purchase the remaining shares. The shares of common stock purchased by the holder upon exercise of the warrant will be deemed to have been issued as of the close of business on the date the warrant is surrendered to us as described above.

The exercise price payable and number of shares purchasable upon exercise of a warrant will generally be adjusted to prevent the dilution of the holder's beneficial interest in the common stock in the event we:

- declare or pay a dividend in shares of common stock or make a distribution of shares of common stock to holders of our outstanding common stock;
- subdivide or combine our common stock; or
- issue shares of our capital stock in any reclassification of our common stock.

Except as described above, a holder of a warrant will not have any of the rights of a holder of common stock before the common stock is purchased upon exercise of the warrant. Therefore, before a warrant is exercised, the holder of the warrant will not be entitled to receive any dividend payments or exercise any voting or other rights associated with the shares of common stock which may be purchased when the warrant is exercised.

The foregoing description of the warrants is qualified in its entirety by reference to the form of warrant that has been filed as an exhibit to the registration statement of which this prospectus is a part, and which is hereby incorporated herein by reference.

LEGAL MATTERS

Lowenstein Sandler PC, Roseland, New Jersey will pass upon the validity of the shares of common stock offered by this prospectus for us.

EXPERTS

Our consolidated financial statements (and schedule) incorporated by reference into this prospectus, and our management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2005 incorporated by reference into this prospectus, have been audited by Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, independent registered public accounting firm, as set forth in its reports thereon, included herein. Such financial statements and management's assessment have been included herein in reliance upon such reports given on the authority of such firm as experts in accounting and auditing.

The financial statements of Armour of America, Incorporated and IES Interactive Training, Inc. referred to in certain of the documents incorporated by reference into this prospectus have been audited by Stark Winter Schenkein & Co., LLP, independent registered public accounting firm, to the extent and for the periods noted herein, in reliance upon such report given upon the authority of said firm as experts in auditing and accounting.

BUSINESS

General

We are a defense and security products and services company, engaged in three business areas: high-level armoring for military and nonmilitary air and ground vehicles; interactive simulation for military, law enforcement and municipal markets; and batteries and charging systems for the military. Until September 17, 2003, we were known as Electric Fuel Corporation. We operate primarily through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned by us, unless otherwise noted) are

as follows:

- We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our ***Simulation and Training Division***:
 - We provide simulators, systems engineering and software products to the United States military, government and private industry through our subsidiary FAAC Incorporated, located in Ann Arbor, Michigan (“FAAC”); and
 - We provide specialized “use of force” training for police, security personnel and the military through our subsidiary IES Interactive Training, Inc., located in Ann Arbor, Michigan (“IES”).
- We utilize sophisticated lightweight materials and advanced engineering processes to manufacture aviation armor and to armor vehicles through our ***Armor Division***:
 - We manufacturer ballistic and fragmentation armor kits for rotary and fixed wing aircraft and marine armor through our subsidiary Armour of America, located in Auburn, Alabama (“AoA”); and
 - We use state-of-the-art lightweight armoring materials, special ballistic glass and advanced engineering processes to fully armor military and civilian SUV’s, buses and vans, through our subsidiaries MDT Protective Industries, Ltd., located in Lod, Israel (“MDT”), of which we own 75.5%, and MDT Armor Corporation, located in Auburn, Alabama (“MDT Armor”), of which we own 88%.
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles through our ***Battery and Power Systems Division***:
 - We develop and sell rechargeable and primary lithium batteries and smart chargers to the military and to private defense industry in the Middle East, Europe and Asia through our subsidiary Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel’s Negev desert area) (“Epsilor”);
 - We manufacture and sell Zinc-Air batteries and battery electronics for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama (“EFB”); and
 - We produce water-activated lifejacket lights for commercial aviation and marine applications, and we conduct our Electric Vehicle effort, through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel (“EFL”).

Background

We were incorporated in Delaware in 1990 under the name “Electric Fuel Corporation,” and we changed our name to “Arotech Corporation” on September 17, 2003. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech’s wholly-owned Israeli subsidiaries, EFL and Epsilor; Arotech’s majority-owned subsidiaries, MDT (in Israel) and MDT Armor (in the U.S.); and Arotech’s wholly-owned United States subsidiaries, EFB, IES, FAAC and AoA.

For financial information concerning the business segments in which we operate, see Note 16 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 have recently been relocated to 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our periodic reports, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this annual prospectus.

The offices and facilities of three of our principal subsidiaries, EFL, MDT and Epsilon, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of the members of our senior management work extensively out of EFL's facilities. IES's and FAAC's home offices and facilities are located in Ann Arbor, Michigan, and the offices and facilities of AoA, EFB and MDT Armor are located in Auburn, Alabama.

Simulation and Training Division

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 Simulation and Training Division, the largest of our three divisions. During 2005, 2004 and 2003 revenues from our Simulation and Training Division were approximately \$26.8 million, \$21.5 million and \$8.0 million, respectively (on a pro forma basis, assuming we had owned all components of our Simulation and Training Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$26.8 million, \$21.5 million and \$17.9 million, respectively).

Vehicle Driving Simulators and Incident Command Training

We provide simulators, systems engineering and software products such as our Incident Command Training product to the United States military, government and private industry through our wholly-owned subsidiary, FAAC Corporation, based in Ann Arbor, Michigan. 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 conscientious equipment operation. We have an installed base of over 270 simulators that have successfully trained hundreds of thousands of drivers. Our customer base includes all branches of the U.S. Department of Defense, state and local governments, and municipal entities.

INTRODUCTION

We conduct our vehicle simulator business in two primary areas: Vehicle Driving Simulations, which focuses on the development and delivery of complete driving simulations for a wide range of vehicle types - such as trucks, automobiles, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles - for municipal, governmental and foreign customers; and Military Operations, which conducts tactical air and land combat analysis and develops analytical models, simulations, and "turnkey" training systems for the U.S. military. In 2005, Vehicle Simulations accounted for approximately 85% of our vehicle simulation revenues, and Military Operations accounted for approximately 15% of our vehicle simulation revenues.

In the area of Military Operations, we are a premier developer of validated, high fidelity analytical models and simulations of tactical air and land warfare 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 ranges (such as Top Gun) to full task training devices such as the F-18 Weapon Tactics Trainer. We are also the leading supplier of wheeled vehicle simulators to the U.S. Armed Forces for mission-critical vehicle training.

We supply on-board software to support weapon launch decisions for the F-15, F-18, and Joint Strike Fighter (JSF) fighter aircraft. Pilots benefit by having highly accurate presentations of their weapon's capabilities, including susceptibility to target defensive reactions. We designed and developed an instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system. The special operational forces aircrew training system provides a full range of aircrew training, including initial qualification, mission qualification, continuation, and upgrade training, as well as combat mission rehearsal.

Simulators are cost-effective solutions, enabling users to reduce overall aircraft and ground vehicle usage, vehicle maintenance costs, fuel costs, repairs, and spares expenditures. For example, our Medium Tactical Vehicle Replacement (MTVR) simulators have reduced total driver training time by 35%. Many customers have reduced actual "behind-the-wheel" time by up to 50% while still maintaining or improving safety. Additionally, for customers with multiple simulators, the corresponding increase in the student to instructor ratio has reduced instructor cost per student.

The implementation of our vehicle driving simulators has led to measurable benefits. North American Van Lines, one of our earliest vehicle simulator customers, has shown a 22% reduction in preventable accidents since it began using our simulators. The German Army, one of our earliest Military Vehicle customers, showed better driver testing scores in 14 of 18 driver skills compared to classroom and live driver training results. Additionally, the New York City Transit Authority documented a 43% reduction in preventable accidents over its first six months of use and has reduced its driver hiring and training "washout" by 50%.

Simulators can produce more drastic situations than can traditional training, which inherently produces drivers that are more skilled in diverse driving conditions. For example, while many first-time drivers will learn to drive during the summer months, they are not trained to drive in wintry conditions. Simulators can produce these and other situations, such as a tire blowout or having to react to a driver cutting off the trainee, effectively preparing the driver for adverse conditions.

We believe that we have held a 100% market share in U.S. military wheeled vehicle operator driver training simulators since 1999 and hold a market share in excess of 50% in U.S. municipal wheeled vehicle simulators.

PRODUCT LINES

Below is a description of our vehicle simulator products and product lines.

Vehicle Driving Simulations

Military Vehicles

Military Vehicles comprise the majority of our vehicle simulation business. Military vehicle simulators are highly realistic vehicle simulators that include variable reactive traffic and road conditions, the capacity to customize driving conditions to be geography-specific, and training in hazardous and emergency conditions. We have several large contracts and task orders in the Military Vehicles business, including (i) a multi-year IDIQ task-order contract for the development of vehicle simulators and related training services for the U.S. armed services; (ii) a series of scheduled General Services Administration purchases of simulators; (iii) Congressional plus-up funding for three simulators to the National Guard in three states; and (iv) a contract to develop a series of Common Driver Trainers for the U.S. Army, the first task order of which is for nine Stryker simulators and a second award for 26 Interim Tactical Wheeled Vehicle Simulators.

Our military vehicle simulators provide complete training capabilities, based on integrated, effective simulation solutions, to military vehicle operators in the U.S. Armed Forces. Our flagship military vehicle simulation product is our Military Operator Driver Simulator, initially developed for the USMC and subsequently reconfigured and delivered to support the U.S. Army and U.S. Naval Construction Battalion. The MIL ODS concept is centered on a pod of up to six Student Training Stations (STS) and a single controlling Instructor Operator Station (IOS). The STS realistically simulates the form, fit, and feel of the vehicle being modeled. The high-fidelity version of the STS consists of a modified production cab unit mounted on a full six-degree-of-freedom motion platform. Other versions with industry exclusive seat-motion and generic reconfigurable cabs are available. The STS provides a field of view of over 180-degrees into a realistically depicted virtual world, simulating a variety of on-road and off-road conditions. The IOS is the main simulation control point supporting the instructor's role in simulator training. The IOS initializes and configures the attached STS, conducts training scenarios, assesses student performance, and maintains scenarios and approved curriculum.

Our software solution provides a complete operator training curriculum based upon integrated simulation training. Military vehicle simulators enable students to learn proper operational techniques under all terrain, weather, road, and traffic conditions. Instructors can use simulators as the primary instructional device, quantitatively evaluating student performance under controlled, repeatable scenarios. This monitoring, combined with the ability to create hazardous and potentially dangerous situations without risk to man or material, results in well-trained students at significantly less cost than through the use of traditional training techniques. In addition to standard on-road driver training, our military vehicle simulators can provide training in such tasks as:

- Off-road driving on severe slopes, including muddy or swampy terrain;
- Driving in night vision goggle and blackout conditions;
- Convoy training; and
- The use of the Central Tire Inflation System in response to changing terrain.

In addition to simulation systems, we offer on-site operator and maintenance staff, train-the-trainer courses, curriculum development, scenario development, system maintenance, software upgrades, and warranty packages to our U.S. Armed Forces customers.

Municipal Vehicles

The Municipal Vehicles business is comprised of technology similar to that of the Military Vehicles product line and also is customized to reflect the specific vehicle being simulated. We serve four primary customer bases in the Municipal Vehicles business: transit, commercial, airport, and other municipal customers.

Transit

Transit customers represent an attractive customer base as they generally have access to their own funds, which often exempts them from the lengthy and complex process of requesting funds from a governing body. We have provided bus simulators to many of the leading U.S. transit authorities, including the New York City Transit Authority, Washington, D.C. Metro, Los Angeles MTA, Dallas Area Rapid Transit, and the Chicago Transit Authority. Our first European bus simulator was installed in London this year, and we were competitively awarded a major rail simulator program with New York City Transit.

Public Safety

We target municipal customers in police departments, hospitals, fire departments, and departments of transportation for sales of our municipal product. Our customers include the Mexico Department of Education, California Department of Transportation, and the Fire Department of New York. We are developing an industry advisory group focusing on the municipal market to identify and address customer needs. Additionally, we have developed a simulator module to extend the simulation once police, fire, or emergency medical service personnel reach the incident location. We believe that this represents another of our bases of differentiation over our competition.

One of our newest products is our Incident Command Training (ICT) system. Our custom ICT systems include a comprehensive suite of simulation tools to promote both strategic and tactical training for firefighters facing incidents that require a well defined command and control structure. The ICT system, the first of which has been installed at the new Los Angeles Fire Fighter Training Academy, includes a broad range of incidents typically faced by firefighters as well as incidents involving weapons of mass destruction (WMD) and other acts of terrorism. The ICT system will provide immersive training for single agency incidents involving the fire service alone, as well as interagency incidents requiring a unified command structure including fire, police, emergency medical services, utilities, and other emergency response agencies.

Corporate

We target corporate fleets and “for-hire” haulers as customers of the corporate simulator product. These customers use simulators to train personnel effectively as well as to avoid the brand damage that could be associated with poor driver performance. To date, we have provided simulators to customers such as Challenger Transportation, Schlumberger Oil Services, Kramer Entertainment, and North American Van Lines.

Military Operations

We provide air combat range software, missile launch envelope decision support software, the SimBuilder™ simulation software product, and Weapon System Trainer software through the Military Operations business line.

Air Combat Range Software

We serve the U.S. Air Force Air Combat Training System and U.S. Navy Tactical Aircrew Training System with our air combat training range software. Air combat training ranges allow pilots to train and evaluate new tactics in a controlled airborne environment. Air “battles” are extremely realistic, with our software determining the outcome of weapon engagements based on launch conditions and the target aircraft defensive reactions.

Missile Launch Envelope Software

Onboard weapon decision-making software enables pilots to assimilate the complex information presented to them. In 2005, we added the F-16 to the F-15, F-18 and Joint Strike Fighter (JSF) fighter to strengthen the list of aircraft fielding FAAC MLE software. We provide our missile launch envelope software to the U.S. Navy and Air Force through our subcontracting relationships with Boeing and Raytheon.

Weapon System Trainer Software

We have successfully transitioned software from U.S. Navy Tactical Aircrew Training Systems to over 15 Weapon Systems Trainers built by prime contractors such as L-3, Boeing, Northrop Grumman, and Lockheed Martin.

SimBuilder™

The SimBuilder™ simulation software product is designed to provide weapons simulation models for use in training environments for launched weapons. This software enables foreign end-users to use weapons simulation models similar to the U.S. military without classified U.S. weapons data. Militaries of Australia, the United Arab Emirates, Canada, Taiwan, and Singapore currently use SimBuilders™.

MARKETING

Our sales and marketing effort focuses on developing new business opportunities as well as generating follow-on sales of simulators and upgrades. Through FAAC, we currently employ four dedicated sales representatives who focus on Municipal Vehicles, Military Operations, and Military Vehicles opportunities. Furthermore, two additional employees spend a significant portion of their time in sales. Various members of FAAC's senior management serve as effective sales representatives in the generation of municipal, military, and corporate business. We also retain the services of several independent consultants who act as marketing agents on our behalf. These representatives are largely commission-based agents who focus on particular products and/or regions (such as airport customers, Texas, California, and Eglin Air Force Base). Finally, we have four customers that have agreements wherein the companies support our marketing efforts and market our products themselves in exchange for commissions and/or free upgrade services.

Our sales representatives are salaried employees with minimal commission-based revenue. Independent consultants generally do not receive a base salary and receive 5% to 10% commissions on the amount of business that they generate each year. The majority of our sales representatives have engineering backgrounds that they leverage to anticipate the technical needs of our customer base and targeted markets. Additionally, the program manager and service department assist us in gaining repeat business.

Developing a pipeline of follow-on work is one of the tasks for all program managers. We have a long history of repeat and follow-on work with programs such as F-15 and F-18 ZAP (over 20 contracts with Boeing), the U.S. Navy Tactical Aircrew Training System (a series of 6 sequential contracts over the last 25 years), and F-18 Weapon Tactics Trainer (series of 20 contracts with the simulator manufacturer).

CUSTOMERS

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, 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 an attractive competitive position. Several potential competitors in the military 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.

We differentiate ourselves from our competition on several bases:

- Leading Technology– We believe that we offer better-developed, more dynamic software than our competitors. Additionally, we incorporate leading graphics and motion-cueing technologies in our systems to provide customers with the most realistic simulation experience on the market.
- Long History in the Simulation Software Business– As a market leader in the simulation software business for more than thirty years, FAAC's professionals understand customer requirements and operating environments. Thus, we build our software to meet and exceed demanding customers' expectations.

- Low-Cost Research and Development Capabilities for New Products– Our customers benefit from government and commercial funding of research and development and the low cost of subsequent adaptation. As such, internally funded new product development costs have been less than \$100,000 per year since 1999.
- Service Reputation– We are known for providing strong customer service, a characteristic that drives new business within our chosen markets.
- Standardized Development Processes– We generally deliver our products to market quickly and at high quality due to our standardized development processes.

Below is a description of our competition organized by product lines.

Vehicle Simulations

Military Vehicles

FAAC has been the sole provider of wheeled vehicle simulation solutions to the U.S. military since 1999. Our devotion to developing realistic, comprehensive products for a wide range of vehicle types positions us as a preferred simulation provider within this market niche. Our strategy of identifying a training need, isolating government funds, and then developing a customized training solution has led to considerable successes. This approach, which differs from the “build first and market later” strategy employed by a number of our competitors, effectively identifies market opportunities and provides a better product to the military customer. Diversified defense companies and municipal simulation providers have attempted to enter the military wheeled vehicle market but have been unsuccessful thus far. Although we believe that market penetration by these companies is ultimately inevitable, the established FAAC brand, understanding of customer requirements, and engineering expertise provide us with a competitive advantage in this market segment. Our primary competitors for military vehicle simulation solutions include Lockheed Martin Corporation’s Information & Technology Services Group, L-3 Communications Holdings, Raydon Corporation, and the Cubic Defense Applications division of Cubic Corporation.

Municipal Vehicles

A handful of simulation product and service companies currently compete with our targeted municipal driving simulator markets. However, our marketing and development of selected municipal market segments has positioned us as a leading provider of municipal simulation solutions. Competition within each market segment varies, but the following companies generally participate in selected driving simulator market opportunities: L-3 Communications Holdings, Doron Precision Systems, Lockheed-Martin Corporation’s LMIS Division, Global SIM, and USADriveSafe, Inc.

Military Operations

Currently no significant competitors participate in the market for our tactical environment software, and there are essentially no independent competitors that exist in the market for our decision support software. Competition for software to support tactical environment requirements in aircraft weapon systems trainers comes from the manufacturers of the simulators themselves and from a handful of companies who produce tactical environment software. Our primary competitors for training range software, decision support software, and weapons system trainer software solutions include Lockheed Martin Corporation, L-3 Communications Holdings, Raytheon Company, Science Applications International Corporation, Dynetics, Inc., and Georgia Tech Research Institute.

Use-of-Force Training

We are a leading provider of interactive, multimedia, fully digital training simulators for law enforcement, security, military and similar applications. With a customer base of over 700 customers in over twenty countries around the world, we are a leader in the supply of simulation training products to military, law enforcement and corporate client communities. We believe, based on our general knowledge of the size of the interactive use-of-force market, our specific knowledge of the extent of our sales, and discussions we have held with customers at trade shows, etc., that we provide more than 25% of the world-wide market for government and military judgment training simulators. We conduct our interactive training activities through our subsidiary IES Interactive Training, Inc. (“IES”), a Delaware corporation based in Ann Arbor, Michigan.

INTRODUCTION

We offer consumers the following interactive training products and services:

- *Range 3000* - providing use-of-force simulation for military and law enforcement. We believe that the Range 3000 is the most technologically advanced judgment training simulator in the world.
- *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.
- *Range FDU (Firearms Diagnostic Unit)* - a unique combination of training and interactive technologies that give instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.
- *Milo (Multiple Interactive Learning/training Objectives)* - a simulator designed with “plug in” modules to customize the training system to meet end user needs.
- *Summit Training International* - providing relevant, cost-effective professional training services and interactive courseware for law enforcement, corrections and corporate clients.
- *IES Studio Productions* - providing cutting edge multimedia video services for law enforcement, military and security agencies, utilizing the newest equipment to create the training services required by the most demanding authorities.

Our products feature state of the art all digital video formats, ultra-advanced laser-based lane detection for optimal accuracy and performance, customer-based authoring of training scenarios, and 95% COTS (commercial off-the-shelf)-based system.

PRODUCTS

Below is a description of each of the core products and services in the IES line.

Range 3000 “Use of Force” Simulator

We believe that the Range 3000, which was launched in late 2002, combines the most powerful operational hardware and software available, and delivers performance superior to competing products presently on the market.

The Range 3000 simulator allows training with respect to the full “Use of Force” continuum. Training can be done on an individual basis, or as many as four members of a team can participate simultaneously and be scored and recorded individually. Topics of training include (but are not limited to):

- *Officer’s Presence and Demeanor* - Picture-on-picture digital recordings of the trainee’s actions allows visual review of the trainee’s reaction, body language and weapons handling during the course of the scenario, which then can be played back for debriefing of the trainee’s actions.
- *Verbalization* - Correct phrases, timing, manner and sequence of an officer’s dialogue is integrated within the platform of the system, allowing the situation to escalate or de-escalate through the officer’s own words in the context of the scenario and in conjunction with the trainer.

- *Less-Than-Lethal Training* - Training in the use of non-lethal devices such as TASER, OC (pepper spray), batons and other devices can be used with the video training scenarios with appropriate reactions of each. We produce an interactive system especially for TASER products called the TASER™ Judgmental Trainer, which delivers advance simulated training for law enforcement and government agencies deploying TASER non-lethal devices.
- *Soft Hand Tactics* - Low level physical control tactics with the use of additional equipment such as take-down dummies can be used.
- *Firearms Training and Basic Marksmanship* - Either utilizing laser based training weapons or in conjunction with a live-fire screen, the use of “Live Ammunition” training can be employed on the system.

The interactive training scenarios are projected either through single or multiple screens and projectors, allowing us to immerse a trainee in true-to-life training scenarios and incorporating one or all the above training issues in the “Use of Force” continuum.

A2Z Classroom Trainer

The A2Z is 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.

Using individual hand-held keypads, the students can answer true/false or multiple choice questions. Based on the student’s performance, the scenario will branch and unfold to a virtually unlimited variety of different possible outcomes of the student’s actions. The system logs and automatically scores each and every trainee’s response and answer. At the end of the scenario, the system displays a session results summary from which the trainer can debrief the class.

The advanced A2Z Courseware Authoring Tools allow the trainer easily to create complete customized interactive courses and scenarios.

The Authoring Tools harness advances in digital video and multimedia, allowing the trainer to capture video and graphics from any source. The A2Z allows the trainer to combine his or her insight, experience and skills to recreate a realistic learning environment. The A2Z Training System is based on the well-known PC-Pentium technology and Windows XP™ operated. The menu and mouse operation make the A2Z user-friendly.

The individual keypads are connected “wirelessly.” The system is completely portable and may be setup within a matter of minutes.

Key advantages:

- Provides repeatable training to a standard based on established policy
- Quick dissemination and reinforcement of correct behavior and policies
- Helps reduce liability
- More efficient than “traditional and redundant” role-playing methods
- Realistic scenarios instead of outdated “play-acting”
- Interactive training of up to 250 students simultaneously with wireless keypads

- Easy Self-Authoring of interactive training content
- PC-Pentium platform facilitates low cost of ownership
- Easy to use Windows XP-based software
- Easy to deploy in any classroom

Range FDU

The Range FDU (firearm diagnostics unit) is a unique combination of training and interactive technologies that gives instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.

With the Range FDU, firearms instructors can see the trainees' actual sight alignment to the target as well as measure trigger pressure against proper trigger pressure graphs, making corrective instruction simple and effective. In addition, the Range FDU records a trainee's recoil control, grip and stance - allowing the instructor to playback the information in slow motion or real time to better analyze the trainee's actions and more accurately diagnose any deficiencies.

The Range FDU also has the ability to record the firearm instruction session to either DVD or VHS, allowing both the trainee and the instructor to review it at a later time. Trainees now have a diagnostic tool that they can learn from, even after their training has been completed. In addition, instructors can build a library for each trainee to record progress.

The Range FDU provides the following benefits:

- Fall of shot feedback
- Trigger pressure analysis
- Recoil control, grip and stance assessment
- Sight alignment
- Sight picture analysis and target reacquisition

Milo

Milo (Multiple Interactive Learning/training Objectives) is a simulator designed with "plug in" modules to customize the trainings system to meet end user needs, and is designed to expand the market for sales of our IES products to include organizations involved in all aspects of public safety, and not just law enforcement.

Professional Conferences and Courseware

We provide relevant, cost-effective professional training seminars, consulting services, and interactive courseware for law enforcement, corrections, and corporate clients through Summit Training International (STI), a wholly-owned subsidiary of IES. The emphasis and goal of our conferences and courseware is to create a "total training" environment designed to address the cutting edge issues faced today. We provide conferences throughout the United States, and develop courseware dealing with these important topics. The incorporation of IES Interactive Systems in our conferences creates an intense learning environment and adds to the realism of the trainee's experience.

Conferences

We have provided conferences throughout the United States, on such topics as:

- Recruiting and Retention of Law Enforcement and Corrections Personnel
- Ethics and Integrity

- Issues of Hate Crimes
- Traffic Stops and Use of Force
- Community and Corporate Partnerships for Public Safety
- Creating a Safe School Environment

In addition to these national and regional conferences, we design and produce training to address specific department issues. We have a distinguished cadre of instructors that allows adaptation of programs to make them specifically focused for a more intense learning experience. The A2Z Classroom Trainer is incorporated into the “live” presentation creating a stimulating interactive training experience.

Courseware

We develop courseware for use exclusively with IES’s interactive systems. Courses are designed to addresses specific department issues, and can be customized to fit each agency’s needs. These courses are available in boxed sets that provide the customer with a turn-key training session. The A2Z Classroom Trainer and the Range 3000 XP-4 are used to deliver the curriculum and create a virtual world that the trainees respond and react to. Strategic relationships with high profile companies such as H&K Firearms, and TASER International, provide customers with training that deals with cutting edge issues facing law enforcement today. The incorporation of our courseware library along with simulation systems allows training to remain consistent and effective, giving customers more value for their training dollar.

IES Studio Productions

Through IES Studio Productions, a division of IES, we provide multimedia video services for law enforcement, military and security agencies, and others and create interactive courseware and interactive scenarios for the Range 3000, Video Training Scenarios and all types of video production services. With the latest in media equipment, we provide all media and marketing services to IES Interactive Training in-house.

MARKETING

We market our IES products and services to domestic and international law enforcement, military and other federal agencies and to various companies that serve them, through attendance and presentations at conferences, exhibits at trade shows, seminars at law enforcement academies and government agencies, through its web pages on the Internet, and to its compiled database of prospect and customer names. Our IES salespeople are also its marketing team. We believe that this is effective for several reasons: (1) customers appreciate talking directly with salespeople who can answer a wide range of technical questions about methods and features, (2) our salespeople benefit from direct customer contact through gaining an appreciation for the environment and problems of the customer, and (3) the relationships we build through peer-to-peer contact are useful in the military, police and federal agency market.

We also use our IES web pages on our Internet site for such activities as providing product information and software updates.

We market augmentative and alternative law enforcement products through a network of employee representatives and independent resellers. These products include but are not limited to products manufactured by:

- Bristlecone Products
- Fox Valley Technical College
- TASER International, Inc.
- Force Science Research Center
- H&K Training Centers

At the present time, we have two full-time and two part-time sales representatives based in Denver, two domestic independent distributors, and ten independent resellers / representatives overseas. We also have inside sales/support persons who answer telephone inquiries on IES's 800 line and Internet, and who can also provide technical support.

We typically participate in over thirty industry conferences annually, held throughout the United States and in other countries, that are attended by our potential customers and their respective purchasing and budgeting decision makers. A significant percentage of our sales of IES products, both software and hardware, are sold through leads developed at these shows.

We and others in the industry demonstrate products at these conferences and present technical papers that describe the application of their technologies and the effectiveness of their products. We also advertise in selected publications of interest to potential customers.

Customers

Most of the customers for our IES products are law enforcement agencies, both in the United States (federal, state and local) and worldwide. Purchasers of IES products have included (in the United States) the FBI, the Secret Service, the Bureau of Alcohol, Tobacco and Firearms, the Customs Service, the Federal Protective Service, the Border Patrol, the Bureau of Engraving and Printing, the Coast Guard, the Federal Law Enforcement Training Centers, the Department of Health and Human Services, the California Department of Corrections, NASA, police departments in Texas (Houston), Michigan (Detroit), Washington, D.C., California (Fresno and the California Highway Patrol), Massachusetts (Brookline), Virginia (Newport News and the State Police Academy), Arizona (various counties), universities and nuclear power plants, as well as international users such as the Israeli Defense Forces, the German National Police, the Royal Thailand Army, the Hong Kong Police, the Russian Security Police, users in Mexico and the United Kingdom, and over 700 other training departments worldwide.

The mix of customers has historically been approximately 40% city and state agencies, 30% federal agencies, and 30% international.

COMPETITION

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 IES's main competitors.

We believe the key factors in our competing successfully in this field will be our ability to develop simulation software and related products and services to effectively train law enforcement and military to today's standards, our ability to develop and maintain a proprietary technologically advanced hardware, and our ability to develop and maintain relationships with departments and government agencies.

Armor Division

We manufacture aviation and other armor and we armor vehicles through our Armor Division. During 2005, 2004 and 2003 revenues from our Armor Division were approximately \$12.3 million, \$18.0 million and \$3.4 million, respectively (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$12.3 million, \$29.2 million and \$10.9 million, respectively).

Aircraft Armoring

INTRODUCTION

Through our subsidiary Armour of America, located in Auburn, Alabama, we manufacture ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles, architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique armored floatation vest that is certified by the U.S. Coast Guard.

For over thirty years, AoA has delivered ballistic armor equipment to users worldwide. Initially, AoA designed and manufactured “soft” ballistic armor only, such as covert and overt ballistic vests, military assault vests, tactical vests and specially designed vests for military and law enforcement users both in the U.S. and abroad. By 1982, AoA had started to design and manufacture “hard” ballistic armor to stop military rifle fire up to and including .50 caliber Armor Piercing Incendiary (API) and European 12.7 mm API rounds. This “hard” ballistic armor is used as chest protection for the full line of personal vests, as well as on fixed wing aircraft (airplanes) and rotary wing aircraft (helicopters), military ships, military vehicles and architectural applications.

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

THE ARMORING PROCESS

Each hard armor kit starts out with detailed templates generated at the aircraft or vehicle, with close fitting around pedals, consoles and other obstructions. These templates are converted into wood patterns that are exact three-dimensional reproductions of the armor to be manufactured, including as to the thickness. These patterns are fitted back into the user’s aircraft or vehicle and approved. At this point, fiberglass over wood production molds are produced for each part, which will guarantee that each production panel will be exactly the same and fit perfectly within the kit. In addition, each kit has a complete set of installation hardware that includes everything required to install the armor kit to the aircraft or vehicle. This total kit package allows the armor to be installed at any location with a minimum of tools required.

Soft armor is manufactured in the same manner as hard armor. Detailed cut and sew patterns are developed from the requirements driven by the customer. These requirements are normally dealing with collar height, placement of pockets and location of plate pockets. Once these patterns are completed, two processes start simultaneously. The first involves spreading multiple plies of ballistic material on a special cutting table. The material is then dusted with pattern powder to mark the packs for cutting. After each pack is cut to size, it is routed to the sew shop for stitching. At the same time, nylon covers are being cut and sewn using sew patterns made from the cut patterns. Upon completion of both the ballistic pack and the cover, the pack is inserted into the cover and sewn closed.

PRODUCT LINES

We produce two kinds of armor, soft armor and hard armor, to support customer armor requirements. Soft armor, which is capable of protecting against all handguns and 9mm sub guns, is used in our ballistic and fragmentation vest, military vehicle, marine, architectural and special application armor lines. Hard armor, which is capable of protecting against rifle fire up to 50cal/12.7mm API, is used in our ballistic chest plate, aircraft, military vehicle, marine and architectural armor lines. Within these two basic kinds of armor, we offer the product lines listed below.

Fixed and Rotary Wing Aircraft Armor Systems

We design and manufacture ballistic armor systems for a wide variety of fixed and rotary wing aircraft. These systems are in the form of kits, with individual contoured panels which cover the entire aircraft’s floor, walls, seats, bulkheads, walls, oxygen containers, avionics and doors. All of our ballistic armor kits include a complete installation hardware kit containing all items required for installation. The supplied hardware is designed for each individual application in accordance with the installation hardware certification, which has been provided by Lockheed-Martin. Additionally, the fixed and rotary wing aircraft kits have been certified, by an independent test facility that is approved by the FAA, to meet flammability requirements of FAA/FAR 25.853, 12 Second Vertical Test and MIL-STD-810 Environmental Testing.

These kits have been sold to both the original airframe manufacturers and end users worldwide. Armor kits for rotary wing aircraft including Bell Helicopter's B206, B212, B407, B412, B427, and UH-1H; Boeing's CH-46 and CH-47; MD Helicopter's MD 500, MD 600, and MD 900; Agusta Helicopter's A109; Eurocopter's EC-120, EC-135, BK117, and BO-105; Aerospatiale's AS 330, AS 332, and AS 355; Sikorsky's UH-60 and S-61; MIL MI-8 and MI-17; Robinson's R-22 and R-44; and Kaman's K-MAX.

Fixed wing aircraft kits include Lockheed's C-130H, C-130J , and P-3; Boeing's C-17; Alenia's G-222 and C-27J; Ayers' T-65; Rockwell's OV-10; CASA CN 235 and CN 295; and special configurations of the Citation, Beechcraft and Cessna models.

Military Vehicles Armor Kits

For the military vehicle market, we provide ballistic armor kits to protect against fragmentation and rifle fire, 2½- and 5-ton trucks, HEMTT wreckers and various construction vehicles. These kits offer varying levels of protection for doors, floors, fuel tanks, air bottles, cargo beds, troop seat backs, critical components and glass. To date, we have protected vehicles deployed in Iraq, Afghanistan, and Kuwait. All of the provided kits are designed for easy field level installation and include required hardware and instructions.

Marine Armor Kits

For the marine market, we manufacture armor kits for the gun mounts on naval ships and riverine patrol boats. During Operation Desert Storm, we designed and manufactured .50 cal AP ballistic panels and deck mount brackets for the U.S. Navy. Since then, we have designed and manufactured armor to fit both the .50 cal and 25mm gun mounts on frigates, destroyers, cruisers and aircraft carriers. The result of this effort is that we have delivered armor systems to individual ships in the class and currently are pursuing armoring additional classes of ships throughout the Navy Command.

Additionally, we have designed program-specific armor for riverine and small boats throughout the world. While the majority of these armoring programs were limited to a small number of boats, the areas of coverage included complete coverage of the exterior walls of the wheel house, forward and aft gun placements, fire boxes, fuel tanks and engines. Unlike designing armor kits for aircraft, this type of armoring requires unique installation methods to allow for interference caused by surface mounted hardware and the impact of "green water" impacting the armor during rough weather.

Ballistic Vests and Plates and Body Armor

We manufacture a complete line of personal body armor, including concealable, external and special application armor. The concealable armor vest offers complete front, side and back protection using soft, lightweight, high strength proprietary woven ballistic fabrics.

Our external vest line includes assault, tactical, riot, stab and T-panel designs. Each of these designs can be modified to meet the individual wearer of customer's requirements. Special application vests include the Armourfloat, which to our knowledge is currently the only ballistic/floating vest approved by the U.S. Coast Guard; the Zip Out armor jacket, which offers covert protection in both a lightweight jacket or vest design; and our helicopter vest, which incorporates a unique protection/comfort design.

We offer a complete line of personal body armor including concealable ballistic vests, military vests and external tactical vests as well as a line of products specially designed for U.S. Navy Seal Teams and various law enforcement agencies in the United States and overseas. Our hard ballistic armor, designed to stop military rifle fire up to and including .50 caliber and European 12.7 mm Armor Piercing Incendiary (API) rounds, is used primarily on fixed and rotary wing aircraft, military ships and military vehicles, as well as in architectural applications.

We have designed and manufactured special operations personal armor including ballistic hand held shields and the LEGUARD Tactical Leg Armor, which offers complete front protection for the lower thigh, knee, shin and instep.

Other Armor for Specialty Applications

In addition to aircraft, marine, vehicle and vest armor, we also manufacture ballistic and fragmentation blankets and curtains for numerous specialty applications. These applications include operator protection around test equipment; rupture protection of pressure vessels, mechanical failure of production machinery and high pressure piping. Additionally, we have supplied armor for office use in protection of occupants from blast and glass fragments of windows and isolation of security rooms from surrounding environments.

SALES, MARKETING AND CUSTOMERS

We maintain broad relationships throughout the aerospace and defense communities, including U.S. federal, state and local government and law enforcement agencies, along with many foreign government end users and procurement agencies.

We market our products directly to both the original airframe manufacturer, such as Alenia, Agusta, Bell-Textron, Boeing, EADS (Eurocopter), Lockheed-Martin and MD Helicopter, as well as, aircraft completion operations and end users worldwide. We maintain a strong presence in Europe, Southeast Asia, Asia, Central America and South America, utilizing key representatives located in each country.

Because of our constant contact with both engineering and marketing at the various airframe manufacturers, we have access to their new and existing model aircraft so that we can always update and/or design new ballistic armor kits to protect the flight deck, cabin, bulkhead and engine areas as required.

At the request of an airframe manufacturer or end user, we send a technical representative to meet the customer at the aircraft to review the layout of areas to be armored, develop templates if required and to determine any unique characteristics that the customer or end user desires incorporated into the armor. After the templates are converted to full size armor mock-up panels, they are taken back to the aircraft for review and approval by either the OEM or the user prior to production. This approach has proven to be the most effective in obtaining both OEM certification of each of our systems and in ensuring that our ballistic armor systems meet or exceed the end users' operational and ballistic demands.

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

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

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

MANUFACTURING

Our manufacturing facilities are located in Auburn, Alabama, and are divided into hard and soft armor production areas. Dedicated cells are established for machining, pressing, cutting, molding, lay-up, assembly and creation of the hard armor panels. The soft armor production area has cells for cutting, sewing and packaging. All of our hard armor is manufactured using AoA-designed production molds, which ensure proper fit of each panel into the total ballistic armor kit.

AoA's entire administrative and manufacturing operations are directed and controlled by procedures conforming to ISO 9001-2000. AoA was certified as ISO 9001-2000 in December 2003.

COMPETITION

Aircraft armor competition includes LAST Armor (a division of Foster-Miller, Inc.), Simula Inc. (a subsidiary of Armor Holdings, Inc.), and Protective Materials Company (a division of The Protective Group, Inc.). Military vehicle armor competition includes: O'Gara-Hess & Eisenhardt (a subsidiary of Armor Holdings, Inc.), ArmorWorks Harl Facility, Protective Materials Company, and Ceradyne, Inc. Ballistic vests competition includes: Point Blank Body Armor, Inc. (a subsidiary of DHB Industries, Inc.), Second Chance Body Armor, Inc., Protective Materials Company, American Body Armor (a subsidiary of Armor Holdings, Inc.), Protech Armor Systems (a subsidiary of Armor Holdings, Inc.) and Safariland, Ltd. (a subsidiary of Armor Holdings, Inc.). Marine armor competition includes Protective Materials Company. Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

Vehicle Armoring

INTRODUCTION

We specialize in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs through our majority-owned subsidiaries, MDT Protective Industries Ltd., located in Lod, Israel, and MDT Armor Corporation, located in Auburn, Alabama. We are a leading supplier to the Israeli military, Israeli special forces and special services. Our products have been proven in intensive battlefield situations and under actual terrorist attack conditions, and are designed to meet the demanding requirements of governmental and private sector customers worldwide.

We have acquired many years of battlefield experience in Israel. Our vehicles have provided proven life-saving protection for their passengers in incidents of rock throwing, handgun and assault rifle attack at point-blank range, roadside bombings and suicide bombings. In fact, to our knowledge an MDT-armored vehicle has never experienced bullet penetration into a vehicle cabin under attack. We also use our technology to protect vehicles against vandalism.

In 2003, we established MDT Armor's operations in a new facility in Auburn, Alabama. Soon thereafter, the United States General Services Administration (GSA) awarded us a five-year contract for vehicle armoring, establishing a pricing schedule for armoring of GM Suburban and Toyota Land Cruiser SUVs and of GM Savana/Express passenger vans. With this contract, these armored vehicles became available for purchase directly by all federal agencies beginning December 1, 2003, and we received our first U.S. orders for vehicle armoring products during 2004.

THE ARMORING PROCESS

Armoring a vehicle involves much more than just adding "armor plates." It includes professional and secure installation of a variety of armor components - inside doors, behind dashboards, and all other areas of passenger and engine compartments. We use overlapping sections to ensure protection from all angles, and install armored glass in the windshield and windows. We have developed certain unique features, such as new window operation mechanisms that can raise windows rapidly despite their increased weight, gun ports, run-flat tires, and more. We developed the majority of the materials that we use in-house or in conjunction with Israeli companies specializing in protective materials.

In order to armor a vehicle, we first disassemble the vehicle and remove the interior paneling, passenger seats, doors, windows, etc. We then fortify the entire body of the vehicle, including the walls, pillars, floors, roof and other critical components, and reinforce the door hinges. We achieve firewall protection from frontal assault with carefully designed overlapping armor. Options, such as air-conditioning, seating modifications and run-flat tires, are also available. We fix the armoring into the shell of the vehicle, ensuring that the installation and finishing is according to the standards set for that particular model. We then reassemble the vehicle as close to its original appearance as possible.

Once we have ensured full vehicle protection, we place a premium on retaining the original vehicle's look and feel to the extent possible, including enabling full serviceability of the vehicle, thereby rendering the armoring process "invisible." We work with our customers to understand their requirements, and together with the customer develop an optimized armoring solution. A flexible design-to-cost process helps evaluate tradeoffs between heavy and light materials and various levels of protection.

By working within the vehicle manufacturer's specifications, we maintain stability, handling, center-of-gravity and overall integrity. Our methods minimize impact on payload, and do not obstruct the driver's or passengers' views. In many cases all the original warranties provided by the manufacturer are still in effect.

ARMORING MATERIALS

We offer a variety of armoring materials, optimized to the customer's requirements. We use ballistic steel, composite materials (including Kevlar®, Dyneema® and composite armor steel) as well as special ceramics, together with special armored glass. We use advanced engineering techniques and "light" composite materials, and avoid, to the extent possible, using traditional "heavy" materials such as armored steel because of the added weight, which impairs the driving performance and handling of the vehicle. We also sell certain kinds of vehicles pre-armored.

All materials that we use meet not only international ballistic standards, but also the far more stringent requirements set down by the Israeli military, the Israeli Ministries of Defense and Transport, and the Israel Standards Institute. Our facilities have also been granted the ISO 9001-2000 quality standards award.

PRODUCTS AND SERVICES

We armor a variety of vehicles for both commercial and military markets.

In the military market, we armor:

- The David, an Ultra Light Armored Vehicle based on a Land Rover or Mercedes platform;
- Command vehicles (such as the Land Rover Defender 110); and
- Pickup trucks such as the Defender 130.

In the commercial market, we armor:

- Sports utility vehicles (such as the GM Suburban, the Toyota Land Cruiser and the Land Rover Defender);
- Trucks, such as the Ford F550;

- Passenger vans (such as the Chevrolet Express, the General Motors Savana and the Ford Econoline); and
- Small buses (based on vehicles in the Mercedes-Benz Vario and Sprinter lines).

SALES, MARKETING AND CUSTOMERS

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

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

We hold exclusive armoring contracts with Israel's sole General Motors and Chevrolet distributors. This means that these distributors will continue to honor the original vehicle warranty on armored versions of vehicles sold by them only if the armoring was done by us.

We are also partners in a joint venture with two prominent Indian companies for the design and manufacture of armored vehicles in India. The joint venture, called Concord Safety Solutions Limited, will offer armored vehicles to the Indian military and paramilitary organizations.

COMPETITION

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

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

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

Battery and Power Systems Division

We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications and we pioneer advancements in Zinc-Air technology for electric vehicles through our Battery and Power Systems Division. During 2005, 2004 and 2003 revenues from our Battery and Power Systems Division were approximately \$9.9 million, \$10.5 million and \$5.9 million, respectively (on a pro forma basis, assuming we had owned all components of our Battery and Power Systems Division since January 1, 2003, revenues in 2005, 2004 and 2003 would have been approximately \$9.9 million, \$10.5 million and \$10.8 million, respectively).

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

We sell lithium batteries and charging systems to the military through our subsidiary Epsilor Electronic Industries, Ltd., an Israeli corporation established in 1985 that we purchased early in 2004.

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

We have opened a lithium battery production and marketing facility at our current Auburn premises. The goal is to penetrate the military lithium battery market in the United States, and also enable U.S.-produced lithium batteries and chargers to be sold using funding from the Foreign Military Sales (FMS) program to countries such as Israel and Turkey.

PRODUCTS

We currently produce over 50 different products in the following categories:

- Primary batteries;
- Rechargeable batteries;
- Smart chargers;
- State of charge indicators; and
- Control and monitoring battery circuits

Our lithium batteries are based on commercially-available battery cells that we purchase from several leading suppliers, with proprietary energy management circuitry and software. Our battery packs are designed to withstand harsh environments, and have a track record of years of service in armies worldwide.

We produce a wide range of primary batteries based on the following chemistries: lithium sulfur dioxide, lithium manganese dioxide and alkaline. The rechargeable battery chemistries that we employ are: nickel cadmium, nickel metal hydride and lithium-ion.

We manufacture single and multi-channel smart chargers for nickel cadmium, nickel metal hydride and lithium-ion batteries.

We have designed a number of sophisticated state of charge indicators. These are employed in our Epsilor products and are also sold as components to other battery pack manufacturers. We also develop and manufacture control systems for high rate primary battery-packs and monitoring systems for rechargeable battery-packs.

MARKETS/APPLICATIONS

Our target markets for our lithium batteries are military and security entities seeking high-end solutions for their power source needs. By their nature, the sell-in cycles are long and the resultant entry barriers are high. This is due to the high cost of developing custom designs and the long period needed to qualify any product for military use.

Our present customers include:

- Armed forces in the Middle East and Asia;
- Military original equipment manufacturers (OEMs); and
- Various battery manufacturers.

COMPETITION

The main competitors for our lithium battery products are Bren-tronics Inc. in the United States, which controls much of the U.S. rechargeable market, AEA Battery Systems (a wholly owned subsidiary of AEA Technology plc) in the United Kingdom, which has the majority of the English military market, and Ultralife Batteries, Inc. On the primary end of the market there are a host of players who include the cell manufacturers themselves, including Saft S.A. and Ultralife Batteries, Inc.

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

MARKETING

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

MANUFACTURING

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

Zinc-Air Fuel Cells, 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 fuel cell technology, as applied in the batteries we produce for the U.S. Army's Communications and Electronics Command (CECOM) through our subsidiary Electric Fuel Battery Corporation. 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.

Since 1998 we have received and performed a series of contracts from CECOM to develop and evaluate advanced primary Zinc-Air fuel cell packs. Pursuant to these contracts, we developed and began selling in 2002 a 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air fuel cell technology, weighs only six pounds and has approximately twice the energy capacity per pound of the U.S. Army's standard lithium-sulfur dioxide battery packs - the BA-8180/U battery.

In the second half of 2002, our five-year program with CECOM to develop a Zinc-Air battery for battlefield power culminated in the assignment of a National Stock Number and a \$2.5 million delivery order for the newly designated BA-8180/U battery. Subsequent to this initial \$2.5 million delivery order, we received additional follow-on orders from the Army.

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

Our Zinc-Air batteries, rechargeable batteries and battery chargers for the military are manufactured through our Electric Fuel Battery Corporation subsidiary. In 2003, our EFB facilities were granted ISO 9001 "Top Quality Standard" certification.

PRODUCTS

Zinc-Air Power Packs

BA-8180/U

Electric Fuel Zinc-Air power packs are lightweight, low-cost primary Zinc-Air batteries with up to twice the energy capacity per pound of primary lithium (LiSO₂) battery packs, which are the most popular batteries used in the US military today. Zinc-Air batteries are inherently safe in storage, transportation, use, and disposal.

The BA-8180/U is a 12/24 volt, 800 watt-hour battery pack approximately the size and weight of a notebook computer. The battery is based on a new generation of lightweight, 30 ampere-hour cells developed by us over the last five years with partial funding by CECOM. Each BA-8180/U battery pack contains 24 cells.

The battery has specific energy of up to 275 Wh/kg, which is substantially higher than that of any competing disposable battery available to the defense and security industries. By way of comparison, the BA-5590, a popular LiSO₂ battery pack, has only 175 Wh/kg. Specific energy, or energy capacity per unit of weight, translates into longer operating times for battery-powered electronic equipment, and greater portability as well. Because of lower cost per watt-hour, the BA-8180/U can provide substantial cost savings to the Army when deployed for longer missions, even for applications that are not man-portable.

CECOM has assigned a National Stock Number (NSN) to our Zinc-Air battery, making it possible to order and stock the battery for use by the Armed Forces. CECOM also assigned the designation BA-8180/U to our Zinc-Air battery, the first time an official US Army battery designation was ever assigned to a Zinc-Air battery.

Based on extensive contacts with the US and foreign military agencies, we believe that a significant market exists for the BA-8180/U both in the US Armed Forces and abroad.

8140/U

The BA-8140/U is a new product that has recently been qualified and that has already generated initial sales of over 5,000 batteries from CECOM. The BA-8140/U is a smaller version of our 8180/U, which we developed at the request of CECOM. It is approximately half the size, weight and capacity of our 8180/U, and is appropriate for smaller hand-held communications devices.

Adapters

The BA-8180/U is a battery, but in order to connect it or the 8140/U to a specific piece of equipment, an adapter must be used. In order to provide compatibility between the battery and various items of military equipment, we supply various types of electrical interface adapters for the BA-8180/U and the 8140/U, including equipment-specific adapters for the AN/PRC-119 SINCGARS and SINCGARS ASIP tactical radio sets, and a generic interface for items of equipment that were designed to interface with a BA-5590 or equivalent battery. Each of the three interfaces was also assigned a national stock number (NSN) by CECOM. In addition, we have recently qualified four more electrical interfaces. These address various applications, including other radios, night vision, missile launchers and chemical detectors.

Hybrids

We have also developed interface adapters for other items of equipment which require higher power than the BA-8180/U can provide by itself. For example, we have developed a hybrid battery system comprising a BA-8180/U battery pack and two small rechargeable lead-acid packs. Even with the weight of the lead-acid batteries, this hybrid system powers a satellite communications terminal for significantly longer than an equivalent weight of BA-5590 LiSO₂ battery packs. We have also developed a hybrid system that incorporates ultracapacitors. We received our first orders for this man-portable hybrid power source from the U.S. Army late in 2005.

Forward Field Chargers

One of the initial goals to develop high energy density and power density Zinc-Air batteries was to deploy them as forward field chargers. It was envisioned that a man portable power pack would be required by the dismounted soldier to charge the range of rechargeable batteries now proliferating in the military. A high efficiency forward field charger has been developed which enables either a BB-390/U (NiMH) or a BB-2590/U (Li-ion) to receive multiple charges from a single BA-8180/U. We are also in the process of developing a forward field charger for the CSEL survival radio.

Other Zinc-Air Products

A fourth generation of Zinc-Air products is being developed for applications where volume is critical, and/or where the power to energy ratio needs to be significantly higher than that of the BA-8180/U. These "Gen4" Zinc-Air products consist of an air cathode folded around a zinc electrode. Gen4 was originally developed for the Marine Corps Dragon Eye UAV, which requires up to 200 W from a battery that fits into its sleek fuselage and which weighs less than one kilogram. Along the way, it was recognized that the Gen4 design could be applied to other battery missions requiring high power as well as energy density, such as Land Warrior and Objective Force Warrior soldier systems, where up to 500 Wh of energy are required of a 24 hour battery that must be worn conformably, at minimal weight. For these systems the battery currently limits functionality, and Gen4 zinc-air may be the enabling technology. During 2004 and 2005, we were awarded \$1.65 million of congressional funds and CECOM funding for the first two phases of a three-phase BAA (Broad Agency Announcement, which is a simplified form of government solicitation for basic research and development) to develop this technology.

We are currently under a multi-year program with an Israeli security agency to demonstrate the feasibility of Zinc-Air batteries for both unmanned aerial vehicles (UAV) and micro-air vehicles (MAV) platforms, respectively. Flights have been demonstrated with a 50W, 200Wh/kg battery for a 500g MAV.

MARKETS/APPLICATIONS

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

- Tactical radios
- SIGINT systems
- Training systems
- SATCOM radios
- Nightscope power
- Guidance systems
- Surveillance systems
- Sensors

CUSTOMERS

The principal customers for our Zinc-Air batteries during 2005 were the U.S. Army's Communications-Electronics Command (CECOM) and the Defense Logistics Agency (DLA).

COMPETITION

The BA-8180/U is the only Zinc-Air battery to hold a US Army battery designation. It does, however, compete with other primary (disposable) batteries, and primarily lithium based batteries. In some cases, primarily in training missions, 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 capacity per pound 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 (LiSO₂) cells. The largest suppliers of LiSO₂ 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 x90 family of batteries, of which the BA-5590 battery is the most commonly deployed. Another primary battery in this family is the BA-5390, which uses lithium-manganese dioxide (LiMnO₂) cells. Suppliers of LiMnO₂ batteries include Ultralife Batteries Inc., Saft and Eagle Picher.

Rechargeable batteries in the x90 family include lithium-ion and nickel-metal hydride batteries which may be used in training missions in order to save the higher costs associated with primary batteries. Because of the short usage time per charge cycle, rechargeable batteries are not considered suitable for use in combat.

Our BA-8180 does not fit inside the 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

We maintain a battery factory for EFB in Auburn, Alabama, where we have leased 15,000 square feet of light industrial space from the city of Auburn. We also have production capabilities for some battery components at the facility of EFL in Beit Shemesh, Israel. Both the facilities in Auburn and those in Beit Shemesh have received ISO 9001 "Top Quality Standard" certification.

Electric Vehicles

INTRODUCTION

We believe that electric buses represent a particularly important market for electric vehicles in the United States. An all-electric, full-size bus powered by the Electric Fuel system can provide to transit authorities a full day's operating range for both heavy duty city and suburban routes in all weather conditions. We conduct our electric vehicle activities through our subsidiary Electric Fuel Ltd.

At this time the technical activity on our Electric Vehicle program is on hold while we seek funding to introduce this technology commercially.

THE ELECTRIC FUEL ZINC-AIR ENERGY SYSTEM FOR ELECTRIC VEHICLES

The Electric Fuel Zinc-Air Energy System consists of:

- an in-vehicle, Zinc-Air fuel cell unit consisting of a series of Zinc-Air cells and refuelable zinc-fuel anode cassettes using commercially-available zinc;
- a battery exchange unit for fast vehicle turn-around that is equivalent to the time needed to refuel a diesel bus;
- an automated battery refueling system for mechanically replacing depleted zinc-fuel cassettes with charged cassettes; and
- a regeneration system for electrochemical recycling and mechanical repacking of the discharged fuel cassettes.

With its proprietary high-power air cathode and zinc anode technologies, our Zinc-Air fuel cell delivers a unique combination of high-energy density and high-power density, which together power electric vehicles with speed, acceleration, driving range and driver convenience similar to that of conventionally powered vehicles.

THE DEPARTMENT OF TRANSPORTATION-FEDERAL TRANSIT ADMINISTRATION ZINC-AIR ALL ELECTRIC TRANSIT BUS PROGRAM

In the United States, our Zinc-Air technology is the focus of a Zinc-Air All Electric Bus demonstration program the costs and expenditures of which are 50% offset by subcontracting fees paid by the U.S. Department of Transportation's Federal Transit Administration (FTA). The test program is designed to prove that an all-electric bus can meet these and all other Los Angeles and New York Municipal Transit Authority mass transit requirements including requirements relating to performance, speed, acceleration and hill climbing.

Phase IV of the program, which we began in October 2003 and which ended in 2005, was a \$1.5 million cost-shared program (half of which was funded by the FTA and the remainder by the program partners, including us) that explored steps necessary for commercializing the all-electric zinc-air/ultra-capacitor hybrid bus. It focused on continued optimization of the propulsion system developed in previous phases, on additional vehicle and system testing, including testing alternative advanced auxiliary battery technologies, and on evaluating alternative zinc anodes, which are more commercially available in North America.

COMPETITION

We believe that our products must be available at a price that is competitive with alternative technologies, particularly those intended for use in zero or low-emission vehicles. Besides other battery technologies, these include hydrogen fuel cells, "hybrid systems" that combine an internal combustion engine and battery technologies, and use of regular or low-pollution fuels such as gasoline, diesel, compressed natural gas, liquefied natural gas, ethanol and methanol. Other alternative technologies presently use costly components, including use of flywheels and catalytic removal of pollutants. These various technologies are at differing stages of development and any one of them, or a new technology, may prove to be more cost effective, or otherwise more readily acceptable by consumers, than the Electric Fuel Zinc-Air Energy System for electric vehicles. In addition, the California Air Resource Board has expressed to us concerns about the costs associated with the Zinc-Air regeneration infrastructure as compared to battery technologies that use electrical recharging.

Lifejacket Lights

PRODUCTS

In 1996, we began to produce and market lifejacket lights built with our patented magnesium-cuprous chloride batteries, which are activated by immersion in water (water-activated batteries), for the aviation and marine safety and emergency markets. Additionally, in 2004 we added two new models to our line of lifejacket light, based on lithium batteries. At present we have a product line consisting of seven lifejacket light models, five for use with marine life jackets and two for use with aviation life vests, all of which work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations. We manufacture, assemble and package all our lifejacket lights through EFL in our factory in Beit Shemesh, Israel.

MARKETING

We market our marine safety products through our own network of distributors in Europe, the United States, Asia and Oceania. We market our lights to the commercial aviation industry through The Burkett Company of Houston, Texas, which receives a commission on sales.

COMPETITION

Two of the largest manufacturers of aviation and marine safety products, including TSO and SOLAS-approved lifejacket lights, are ACR Electronics Inc. of Hollywood, Florida, and Pains Wessex McMurdo Ltd. of England. Other significant competitors in the marine market include Daniamant Aps of Denmark, 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, 2005 and 2004, our backlog for the following years was approximately \$18.3 million and \$25.0 million, respectively, divided among our divisions as follows:

Division	2005	2004
Simulation and Training Division	\$ 9,379,000	\$ 12,691,000
Battery and Power Systems Division	4,523,000	8,325,000
Armor Division	4,440,000	4,002,000
TOTAL:	<u>\$ 18,342,000</u>	<u>\$ 25,018,000</u>

Major Customers

During 2005, including all of our divisions, various branches of the United States military accounted for approximately 33% of our revenues.

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, 2005, 2004 and 2003, our gross research and product development expenditures were approximately \$1.3 million, \$1.7 million and \$1.1 million, respectively, including research and development in discontinued operations. During these periods, the Office of the Chief Scientist of the Israel Ministry of Industry and Trade (the “Chief Scientist”) participated in our research and development efforts relating to our consumer battery business, thereby reducing our gross research and product development expenditures in the amounts of approximately \$0, \$0 and \$26,000 for the years 2005, 2004 and 2003, respectively.

EFL has certain contingent royalty obligations to Chief Scientist and the Israel-U.S. Binational Industrial Research and Development Foundation (BIRD, which apply (in respect of continuing operations) only to our Electric Vehicle program. As of December 31, 2005, our total outstanding contingent liability in this connection was approximately \$11.0 million.

Employees

As of February 28, 2006, we had 277 full-time employees worldwide. Of these employees, 4 hold doctoral degrees and 21 hold other advanced degrees. Of the total, 70 employees were engaged in product research and development, 132 were engaged in production and operations, 17 were engaged in marketing and sales, and 58 were engaged in general and administrative functions. Our success will depend in large part on our ability to attract and retain skilled and experienced employees.

We and our employees are not parties to any collective bargaining agreements. However, as certain of our employees are located in Israel and employed by EFL, MDT or Epsilor, certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Manufacturers’ Association of Israel) are applicable to EFL’s, MDT’s and Epsilor’s employees by order (the “Extension Order”) of the Israeli Ministry of Labor and Welfare. These provisions principally concern the length of the work day and the work week, minimum wages for workers, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment, including certain automatic salary adjustments based on changes in the Israeli CPI.

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 “Executive Compensation - Employment Contracts,” below. We currently fund our ongoing severance obligations by making monthly payments to approved severance funds or insurance policies. In addition, Israeli employees and employers are required to pay specified sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Since January 1, 1995, such amounts also include payments for national health insurance. The payments to the National Insurance Institute are approximately 15.6% of wages, of which the employee contributes approximately 62% and the employer contributes approximately 38%. The majority of the permanent employees of EFL, about a quarter of the permanent employees of MDT, and one of the permanent employees of Epsilor, are covered by “managers’ insurance,” which provides life and pension insurance coverage with customary benefits to employees, including retirement and severance benefits. We contribute 14.33% to 15.83% (depending on the employee) of base wages to such plans and the permanent employees contribute 5% of their base wages.

In 1993, an Israeli court held that companies that are subject to the Extension Order are required to make pension contributions exclusively through contributions to Mivtachim Social Institute of Employees Ltd., a pension fund managed by the Histadrut. We subsequently reached an agreement with Mivtachim with respect to providing coverage to certain production employees and bringing ourselves into conformity with the court decision. The agreement does not materially increase our pension costs or otherwise materially adversely affect its operations. Mivtachim has agreed not to assert any claim against us with respect to any of our past practices relating to this matter. Although the arrangement does not bind employees with respect to instituting claims relating to any nonconformity by us, we believe that the likelihood of the assertion of claims by employees is low and that any potential claims by employees against us, if successful, would not result in any material liability to us.

PROPERTIES

Our primary executive offices are located in FAAC's offices, consisting of approximately 17,800 square feet of office and warehouse space in Ann Arbor, Michigan, pursuant to a lease expiring in January 2008. FAAC has also leased 10,900 square feet of office and warehouse space in Ann Arbor, Michigan pursuant to a lease beginning in June 2006 and expiring in January 2008, for use by IES.

AoA, EFB and MDT Armor operate out of our Auburn, Alabama facilities, constituting approximately 30,000 square feet, which is leased from the City of Auburn through December 2008.

Our management and administrative facilities and research, development and production facilities for the manufacture and assembly of our Survivor Locator Lights, constituting approximately 18,300 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, 2007; we have the ability to terminate the lease every two years upon three months' written notice. Moreover, we may terminate the lease at any time upon twelve months written notice. Most of the members of our senior management, including our Chief Executive Officer and our Chief Operating Officer, work extensively out of our Beit Shemesh facility. Our Chief Financial Officer works out of our Ann Arbor, Michigan facility.

Our Epsilon subsidiary rents approximately 19,000 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.

Our MDT subsidiary rents approximately 20,000 square feet of office space in Lod, Israel, near Ben-Gurion International airport (within Israel's pre-1967 borders) pursuant to a lease renewable on an annual basis.

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

LEGAL PROCEEDINGS

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

In December 2004, AoA filed an action in the United States Court of Federal Claims against the United States Naval Air Systems Command (NAVAIR), seeking approximately \$2.2 million in damages for NAVAIR's alleged improper termination of a contract for the design, test and manufacture of a lightweight armor replacement system for the United States Marine Corps CH-46E rotor helicopter. NAVAIR, in its answer, counterclaimed for approximately \$2.1 million in alleged procurement and administrative costs.

In connection with our acquisition of FAAC, we had a contingent earnout obligation in an amount equal to the net income realized by us from certain specific programs that were identified by us and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. Through June 30, 2006, we had accrued an amount of \$603,764 in respect of such earnout obligation against FAAC's goodwill. In May 2006, the former shareholders of FAAC brought an arbitration action in Michigan against us alleging that the specific programs identified include more orders than those with respect to which we had made accrual in respect of this earnout obligation, and seeking an additional \$3.1 million. In August 2006, we settled this arbitration for a payment by us of \$1.2 million (including the \$603,764 that we had previously accrued) to be paid out \$500,000 in a cash payment that was made on August 23, 2006, and the remainder over the course of 18 months in installments, with a discount of \$150,000 if all installments are timely made.

MARKET FOR REGISTRANT'S COMMON EQUITY AND RE-LATED STOCKHOLDER MATTERS

Our common stock is traded on the Nasdaq Global Market (formerly known as the Nasdaq National 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/National Market System; such prices have been adjusted to reflect the one-for-fourteen reverse stock split effected on June 21, 2006:

Year Ended December 31, 2006

	<u>High</u>	<u>Low</u>
Third Quarter (through August 24, 2006)	\$ 3.92	\$ 2.31
Second Quarter	\$ 8.12	\$ 2.30
First Quarter	\$ 8.96	\$ 5.18

Year Ended December 31, 2005

	<u>High</u>	<u>Low</u>
Fourth Quarter	\$ 10.64	\$ 5.04
Third Quarter	\$ 16.66	\$ 9.80
Second Quarter	\$ 20.44	\$ 14.00
First Quarter	\$ 24.92	\$ 17.64

Year Ended December 31, 2004

	<u>High</u>	<u>Low</u>
Fourth Quarter	\$ 30.24	\$ 21.00
Third Quarter	\$ 29.96	\$ 16.52
Second Quarter	\$ 60.76	\$ 26.60
First Quarter	\$ 35.42	\$ 23.10

As of April 21, 2006 we had approximately 322 holders of record of our common stock. The last sale price of our common stock as reported on the Nasdaq Global Market on August 24, 2006 was \$2.49 per share.

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.

SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial information set forth below with respect to the consolidated statement of operations for each of the five fiscal years in the period ended December 31, 2005, and with respect to the balance sheets at the end of each such fiscal year has been derived from our consolidated financial statements.

The selected consolidated financial information as of June 30, 2005 and 2006 and for the six months ended June 30, 2005 and 2006 are unaudited but have been prepared on the same basis as our consolidated financial statements. Results of operations for interim periods are not necessarily indicative of results for the full year. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

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

The Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated.

The financial information set forth below is qualified by and should be read in conjunction with the Consolidated Financial Statements incorporated by reference into this prospectus and the notes thereto and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” below.

	Year Ended December 31,					Six Months Ended June 30,	
	2001	2002	2003**	2004	2005	2005	2006
	(dollars in thousands)						
Consolidated Statement of Operations Data:							
Revenues	\$ 2,094	\$ 6,407	\$ 17,326	\$ 49,954	\$ 49,045	\$ 22,624	\$ 16,311
Cost of revenues	1,992	4,422	11,088	34,011	34,384	14,981	12,742
Research and development expenses	456	686	1,053	1,731	1,300	899	521
Selling, general and administrative expenses and their impairment and amortization of intangible assets	3,934	5,982	10,255	18,394	34,662	11,497	9,164
Operating loss	(4,288)	(4,683)	(5,070)	(4,182)	(21,301)	(6,234)	(6,116)
Other income	-	-	-	-	339	-	36
Financial income (expenses), net	263	100	4,039	4,229	(2,706)	(1,306)	(6,459)
Loss before minority interest in (loss) earnings of subsidiary and tax expenses	(4,026)	(4,583)	(9,109)	(8,411)	(23,668)	(7,541)	(12,539)
Taxes on income	-	-	(396)	(586)	(237)	(267)	(55)
Earnings (loss) from affiliated company	-	-	-	-	(75)	-	138
Minority interest in (loss) earnings of subsidiary	-	(355)	157	(45)	57	(71)	26
Loss from continuing operations	(4,026)	(4,938)	(9,348)	(9,042)	(23,923)	(7,879)	(12,429)
Income (loss) from discontinued operations	(13,261)	(13,566)	110	-	(120)	(200)	-
Net loss for the period	(17,287)	(18,504)	(9,238)	(9,042)	(24,043)	(8,079)	(12,429)
Deemed dividend to certain stockholders of common stock	(1,197)	-	(350)	(3,329)	-	-	(434)
Net loss attributable to stockholders of common stock	<u>\$ (18,483)</u>	<u>\$ (18,504)</u>	<u>\$ (9,588)</u>	<u>\$ (12,371)</u>	<u>\$ (24,043)</u>	<u>\$ (8,079)</u>	<u>\$ (12,863)</u>
Basic and diluted net loss per share from continuing operations	<u>\$ (3.02)</u>	<u>\$ (2.13)</u>	<u>\$ (3.33)</u>	<u>\$ (1.81)</u>	<u>\$ (4.09)</u>	<u>\$ (1.37)</u>	<u>\$ (1.67)</u>
Loss per share for combined operations	<u>\$ (10.69)</u>	<u>\$ (8.00)</u>	<u>\$ (3.45)</u>	<u>\$ (2.48)</u>	<u>\$ (4.09)</u>	<u>\$ (1.41)</u>	<u>\$ (1.73)</u>
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands)	1,729	2,313	2,778	4,995	5,872	5,746	7,438

	As at December 31,					As at June 30,	
	2001	2002	2003**	2004	2005	2005	2006
	(dollars in thousands)						
Consolidated Balance Sheet Data:							
Cash, cash equivalents, investments in marketable debt securities and restricted collateral deposits	\$ 12,672	\$ 2,091	\$ 14,391	\$ 13,832	\$ 10,084	\$ 5,192	\$ 12,888
Receivables and other assets*	11,515	7,895	8,898	25,746	29,758	25,182	25,214
Property and equipment, net of depreciation	2,221	2,555	2,293	4,601	4,290	4,328	4,026
Goodwill and other intangible assets, net	-	7,522	7,440	54,113	40,587	49,592	40,243
Total assets	\$ 26,408	\$ 20,063	\$ 33,022	\$ 98,292	\$ 84,719	\$ 84,294	\$ 82,371
Current liabilities*	\$ 3,874	\$ 7,272	\$ 6,710	\$ 26,381	\$ 26,167	\$ 19,396	\$ 25,098
Long-term liabilities***	3,126	3,753	4,686	6,438	12,287	6,384	5,043
Stockholders' equity	19,408	9,038	21,626	65,473	46,265	58,514	52,231
Total liabilities and stockholders equity*	\$ 26,408	\$ 20,063	\$ 33,022	\$ 98,292	\$ 84,719	\$ 84,294	\$ 82,371

*Includes long-term restricted deposits and assets and liabilities, as applicable, from discontinued operations.

**Restated.

***Includes minority interest.

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 prospectus. 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 incorporated by reference into this prospectus, and the notes thereto. We have rounded amounts reported here to the nearest thousand, unless such amounts are more than 1.0 million, in which event we have rounded such amounts to the nearest hundred thousand.

General

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

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

During 2004, we acquired three new businesses: FAAC Corporation, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (which we have placed in our Simulation and Training Division); Epsilon Electronic Industries, Ltd., located in Dimona, Israel, which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia (which we have placed in our Battery and Power Systems Division); and Armour of America, Incorporated, located in Auburn, Alabama, which manufactures aviation armor both for helicopters and for fixed wing aircraft, marine armor, personnel armor, armoring kits for military vehicles, fragmentation blankets and a unique ballistic/flotation vest (ArmourFloat) that is U.S. Coast Guard-certified, which we have placed in our Armor Division. Our financial results for 2004 do not include the activities of FAAC, Epsilon or AoA for the full year and therefore are not directly comparable to our financial results for 2005.

Critical Accounting Policies

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

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

Revenue Recognition

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

A portion of our revenue is derived from license agreements that entail the customization of FAAC's simulators to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with Statement of Position 81-1 "Accounting for Performance of Construction - Type and Certain Production - Type Contracts" 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 SOP 97-2, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants and as amended by SOP 98-4 and SOP 98-9 and related interpretations. We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

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

Allowance for Doubtful Accounts

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

Accounting for Income Taxes

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

We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("Statement 109"), 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. The Company and its subsidiaries provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. The company does not provide for US 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.

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

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2005, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

Under Financial Accounting Standards Board Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS 142.

During 2005, we performed an impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows, as a response to several factors, including without limitation the reduced sales in AoA (a component of our Armor Division), the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA and us, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular - specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), and the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, the appropriation of substantial funds earmarked for defense was delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, we identified in AoA an impairment of goodwill in the amount of \$11,757,812.

In connection with our acquisition of AoA, we have a contingent earnout obligation in an amount equal to the revenues realized by us from certain specific programs that were identified by us and the former shareholder of AoA as appropriate targets for revenue increases. The earnout provides that if AoA receives certain types of orders from certain specific customers prior to December 31, 2006 ("Additional Orders"), then upon shipment of goods in connection with such Additional Orders, the former shareholder of AoA will be paid an earnout based on revenues, up to a maximum of an additional \$6 million. As of December 31, 2005, we have accrued a liability of \$1,204,150 in respect of such earnout obligation.

We determine fair value using 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. 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.

Other Intangible Assets

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

The determination of the value of such intangible assets requires us to make assumptions regarding future business conditions and operating results in order to estimate future cash flows and other factors to determine the fair value of the respective assets. If these estimates or the related assumptions change in the future, we could be required to record additional impairment charges. As of December 31, 2004, we identified an impairment of the technology previously purchased from Bristlecone and, as a result, we recorded an impairment loss in the amount of \$320,279. As of December 31, 2005, we identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$498,944.

Contingencies

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

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

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

Warranty Reserves

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

Functional Currency

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

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

Recent Developments

Settlement of FAAC Arbitration

In connection with our acquisition of FAAC, we had a contingent earnout obligation in an amount equal to the net income realized by us from certain specific programs that were identified by us and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. Through June 30, 2006, we had accrued an amount of \$603,764 in respect of such earnout obligation against FAAC's goodwill. In May 2006, the former shareholders of FAAC brought an arbitration action in Michigan against us alleging that the specific programs identified include more orders than those with respect to which we had made accrual in respect of this earnout obligation, and seeking an additional \$3.1 million. In August 2006, we settled this arbitration for a payment by us of \$1.2 million (including the \$603,764 that we had previously accrued) to be paid out \$500,000 in a cash payment that was made on August 23, 2006, and the remainder over 18 months, with a discount of \$150,000 if all installments of the \$700,000 remainder are timely made.

Executive Summary

Divisions and Subsidiaries

We operate primarily as a holding company, through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned, unless otherwise noted) are as follows:

➤ Our ***Simulation and Training Division***, consisting of:

- FAAC Incorporated, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (“FAAC”); and
- IES Interactive Training, Inc., located in Ann Arbor, Michigan, which provides specialized “use of force” training for police, security personnel and the military (“IES”).

➤ Our ***Armor Division***, consisting of:

- Armour of America, located in Auburn, Alabama, which manufacturers ballistic and fragmentation armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles and architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique vest that is certified by the U.S. Coast Guard (“AoA”);
- MDT Protective Industries, Ltd., located in Lod, Israel, which specializes in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs, and is a leading supplier to the Israeli military, Israeli special forces and special services (“MDT”) (75.5% owned); and
- MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT’s United States activities (“MDT Armor”) (88% owned).

➤ Our ***Battery and Power Systems Division***, consisting of:

- Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel’s Negev desert area), which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia (“Epsilor”);
- Electric Fuel Battery Corporation, located in Auburn, Alabama, which manufactures and sells Zinc-Air fuel cells, batteries and chargers for the military, focusing on applications that demand high energy and light weight (“EFB”); and
- Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel, which produces water-activated lifejacket lights for commercial aviation and marine applications, and which conducts our Electric Vehicle effort, focusing on obtaining and implementing demonstration projects in the U.S. and Europe, and on building broad industry partnerships that can lead to eventual commercialization of our Zinc-Air energy system for electric vehicles (“EFL”).

Overview of Results of Operations

We incurred significant operating losses for the years ended December 31, 2005, 2004 and 2003 and for the six months ended June 30, 2006. While we expect to continue to derive revenues from the sale of products that we manufacture and the services that we provide, there can be no assurance that we will be able to achieve or maintain profitability on a consistent basis.

During 2003 and 2004, we substantially increased our revenues and reduced our net loss, from \$18.5 million in 2002 to \$9.2 million in 2003 to \$9.0 million in 2004. This was achieved through a combination of cost-cutting measures and increased revenues, particularly from the sale of Zinc-Air batteries to the military and from sales of products manufactured by the subsidiaries we acquired in 2002 and 2004. However, in 2005 our net loss increased to \$23.9 million on revenues of \$49.0 million, and in the first six months of 2006 we had a net loss of \$12.4 million on revenues of \$16.3 million. About half of the 2005 loss was the result of impairments during 2005 of goodwill and other intangible assets in connection with our AoA subsidiary; the remainder of the increase in net loss was attributable to the factors cited below.

A portion of our operating loss during 2003, 2004, 2005 and the first six months of 2006 arose as a result of non-cash charges. In addition to the charges in respect of write-offs of goodwill and other intangible assets described under “Critical Accounting Policies - Goodwill,” above, these charges were primarily related to our acquisitions, financings and issuances of restricted shares and options to employees. Because we anticipate continuing certain of these activities during the remainder of 2006, we 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 will continue during 2006. We are required to review intangible assets for impairment whenever events or changes in circumstances indicate that carrying amount of the assets may not be recoverable. If we determine, through the impairment review process, that intangible asset has been impaired, we must record the impairment charge in our statement of operations.

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

As a result of the application of the above accounting rule, we incurred non-cash charges for amortization of intangible assets in the amount of \$3.1 million during 2005. In addition, we incurred non-cash charges for impairment of goodwill and other intangible assets in the amount of \$12.3 million during 2005, primarily in respect of AoA. We also incurred non-cash charges for amortization of intangible assets in the amount of \$971,000 during the first six months of 2006. In addition, we incurred non-cash charges for impairment of goodwill in the amount of \$204,000 during the first six months of 2006 in respect of our subsidiary AoA. See “Critical Accounting Policies - Other Intangible Assets,” above.

FINANCINGS

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

As a result of the application of the above accounting rule, we incurred non-cash charges related to amortization of debt discount attributable to beneficial conversion feature in the amount of \$1.7 million during 2005. We also incurred non-cash charges related to amortization of debt discount attributable to beneficial conversion feature in the amount of \$1.0 million during the first six months of 2006.

ISSUANCES OF RESTRICTED SHARES, OPTIONS AND WARRANTS

During 2004 and 2005, we issued restricted shares to certain of our employees. These shares were issued as stock bonuses, and are restricted for a period of two years from the date of issuance. Relevant accounting rules provide that the aggregate amount of the difference between the purchase price of the restricted shares (in this case, generally zero) and the market price of the shares on the date of grant is taken as a general and administrative expense, amortized over the life of the period of the restriction.

As a result of the application of the above accounting rules, we incurred non-cash charges related to stock-based compensation in the amount of \$521,000 during 2005. We also incurred non-cash charges related to stock-based compensation in the amount of \$225,000 during the first six months of 2006.

As a result of options granted to employees, we incurred non-cash charges related to stock-based compensation in the amount of \$154,000 during 2005. We also incurred non-cash charges related to stock-based compensation in the amount of \$85,000 during the first six months of 2006.

As a result of shares granted to consultants and shares granted as a donation, we incurred non-cash charges related to stock-based compensation in the amount of \$538,000 during 2005.

As part of our Securities Purchase Agreement dated September 29, 2005 (see Note 12.d. of the Notes to Consolidated Financial Statements), we issued warrants to purchase up to 375,000 shares of common stock. Because the terms of the warrants referred to above provided that upon exercise of a warrant we could issue only stock that had been registered with the SEC (which occurred in December 2005) and was therefore freely tradable, in accordance with Emerging Issues Task Force No 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the fair value of the warrants was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. The fair value of these warrants was remeasured as at December 31, 2005 using the Black-Scholes pricing model assuming a risk free interest rate of 3.87%, a volatility factor of 64%, dividend yields of 0% and a contractual life of approximately one year. The change in the fair value of the warrants between the date of the grant and December 31, 2005 in the amount of \$377,803 has been recorded as finance income.

As part of the repricings and exercises of warrants described in Note 6 to our interim financial statements for the three- and six-months ended June 30, 2006, we issued warrants to purchase up to 298,221 shares of common stock. Since the terms of these warrants provided that the warrants were exercisable subject to the Company obtaining shareholder approval, in accordance with Emerging Issues Task Force No 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the fair value of the warrants was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date until we obtained shareholders approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the shareholders approval) using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$739,000 has been recorded as finance income.

Under the terms of our convertible notes, we have the option in respect of scheduled principal repayments to force conversion of the payment amount at a conversion price based upon the weighted average trading price of our common stock during the 20 trading days prior to the conversion, less a discount of 8%. Because of this discount and the use in a conversion price that is based on the weighted average trading price of our common stock during the 20 trading days prior to the conversion, we incurred a financial expense during the first six months of 2006 of \$507,000, which represents the shares issued multiplied by the difference between the share price that was used for the conversion and the share price at the day of the conversion.

On April 7, 2006, we and each holder of our convertible notes agreed that we would force immediate conversion of an aggregate of \$6,148,904 principal amount of the convertible notes into 1,098,019 shares of our common stock. The amount converted eliminated our obligation to make the installment payments under the convertible notes on each of March 31, 2008, January 31, 2008, November 30, 2007 and September 30, 2007 (aggregating a total of \$5,833,333). In addition, as a result of the conversion an additional \$315,570 was applied against part of the installment payment due July 31, 2007. After giving effect to the conversion, \$8,434,430 of principal remained outstanding under the convertible notes. As a result of this transaction, we incurred a financial expense during the first six months of 2006 of \$4.9 million.

Additionally, in an effort to improve our cash situation and our shareholders' equity, we have periodically induced holders of certain of our warrants to exercise their warrants by lowering the exercise price of the warrants in exchange for immediate exercise of such warrants, and by issuing to such investors new warrants. Under such circumstances, we record a deemed dividend in an amount determined based upon the fair value of the new warrants (using the Black-Scholes pricing model). As and to the extent that we engage in similar warrant repricings and issuances in the future, we would incur similar non-cash charges.

As a result of the application of the above accounting rule we recorded a deemed dividend related to repricing of warrants and the grant of new warrants in the amount of \$434,000 during the first six months of 2006.

Overview of Financial Condition and Operating Performance

We shut down our money-losing consumer battery operations and began acquiring new businesses in the defense and security field in 2002. Thereafter, we concentrated on eliminating our operating deficit and moving Arotech to positive EBITDA, a goal we achieved for the first time in our history in the second half of 2004, in part through the acquisition of businesses with strong revenues and profitable operations; however, we did not achieve such results in 2005.

In our Simulation and Training Division, revenues grew from approximately \$21.5 million in 2004 to \$26.8 million in 2005. We attribute this to the receipt by our FAAC subsidiary of a number of substantial orders from, for example, the United States Army. Revenues decreased from approximately \$9.6 million in the first six months of 2005 to \$9.4 million in the first six months of 2006. As of June 30, 2006, our funded backlog for our Simulation and Training Division totaled \$11.7 million.

Our Armor Division had disappointing revenues during 2005, with revenues falling from approximately \$18.0 million in 2004 to \$12.3 million in 2005 (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2004, revenues would have fallen from approximately \$29.2 million in 2004 to \$12.3 million in 2005). Revenues decreased from \$7.9 million during the first six months of 2005 to \$2.7 million during the first six months of 2006. We attribute this to the unsatisfactory results of our MDT Armor subsidiary. As of June 30, 2006, our backlog for our Armor Division totaled \$25.0 million.

In our Battery and Power Systems Division, revenues fell from approximately \$10.5 million in 2004 to \$9.9 million in 2005. We attribute this to reduced equipment purchases by one of the customers of our Epsilon subsidiary. Revenues decreased from approximately \$5.1 million in the first six months of 2005 to approximately \$4.1 million in the first six months of 2006. As of June 30, 2006, our backlog for our Battery and Power Systems Division totaled \$5.8 million.

Recent Developments

Reverse Stock Split

In June 2006, our stockholders voted to effect a one-for-fourteen reverse stock split, which became effective at the opening of trade on June 21, 2006.

Results of Operations

Preliminary Note

SUMMARY

Results of operations for the years ended December 31, 2005 and 2004 include the results of FAAC and Epsilor from January 2004 and AoA from August 2004. However, the results of these subsidiaries were not included in our operating results for the year ended December 31, 2003. Additionally, AoA's results are reflected in all of 2005 but only part of 2004. Accordingly, the following year-to-year comparisons should not necessarily be relied upon as indications of future performance.

Following is a table summarizing our results of operations for the years ended December 31, 2005, 2004 and 2003, after which we present a narrative discussion and analysis:

	Year Ended December 31,		
	2005	2004	2003*
Revenues:			
Simulation and Training Division	\$ 26,805,772	\$ 21,464,406	\$ 8,022,026
Armor Division	12,322,678	17,988,687	3,435,716
Battery and Power Systems Division	9,916,145	10,500,753	5,868,899
	<u>\$ 49,044,595</u>	<u>\$ 49,953,846</u>	<u>\$ 17,326,641</u>
Cost of revenues:			
Simulation and Training Division	\$ 15,835,735	\$ 11,739,690	\$ 3,944,701
Armor Division	11,206,442	15,449,084	2,621,550
Battery and Power Systems Division	7,341,559	6,822,320	4,521,589
	<u>\$ 34,383,736</u>	<u>\$ 34,011,094</u>	<u>\$ 11,087,840</u>
Research and development expenses:			
Simulation and Training Division	\$ 209,554	\$ 395,636	\$ 132,615
Armor Division	139,514	17,065	84,186
Battery and Power Systems Division	951,361	1,318,678	836,607
	<u>\$ 1,300,429</u>	<u>\$ 1,731,379</u>	<u>\$ 1,053,408</u>
Sales and marketing expenses:			
Simulation and Training Division	\$ 2,704,880	\$ 3,185,001	\$ 2,237,386
Armor Division	834,090	565,981	180,631
Battery and Power Systems Division	853,378	1,171,235	926,872
All Other	79,242	-	187,747
	<u>\$ 4,471,590</u>	<u>\$ 4,922,217</u>	<u>\$ 3,532,636</u>
General and administrative expenses:			
Simulation and Training Division	\$ 3,849,881	\$ 2,852,969	\$ 1,001,404
Armor Division	2,181,355	1,323,982	518,053
Battery and Power Systems Division	974,704	965,058	188,655
All Other	7,856,495	5,514,857	4,149,764
	<u>\$ 14,862,435</u>	<u>\$ 10,656,866</u>	<u>\$ 5,857,876</u>
Other income:			
Simulation and Training Division	\$ 338,900	\$ -	\$ -
Armor Division	-	-	-
Battery and Power Systems Division	-	-	-
All Other	-	-	-
	<u>\$ 338,900</u>	<u>\$ -</u>	<u>\$ -</u>
Financial expense (income):			
Simulation and Training Division	\$ 22,294	\$ 27,842	\$ (119,750)

Armor Division	(2,463)	13,503	(19,918)
Battery and Power Systems Division	122,236	54,511	7,936
All Other	2,563,622	4,133,109	4,170,441
	\$ 2,705,689	\$ 4,228,965	\$ 4,038,709
<i>Tax expenses:</i>			
Simulation and Training Division	\$ 63,976	\$ 77,811	\$ 30,130
Armor Division	94,671	134,949	363,173
Battery and Power Systems Division	32,846	320,878	-
All Other	46,179	52,471	2,890
	\$ 237,672	\$ 586,109	\$ 396,193

	Year Ended December 31,		
	2005	2004	2003*
Amortization of intangible assets:			
Simulation and Training Division	\$ 1,213,261	\$ 1,323,403	\$ 720,410
Armor Division	1,348,248	661,914	144,500
Battery and Power Systems Division	509,239	509,239	-
	<u>\$ 3,070,748</u>	<u>\$ 2,494,556</u>	<u>\$ 864,910</u>
Impairment of goodwill and other intangible assets:			
Simulation and Training Division	\$ -	\$ 320,279	\$ -
Armor Division	12,256,756	-	156,900
Battery and Power Systems Division	-	-	-
	<u>\$ 12,256,756</u>	<u>\$ 320,279</u>	<u>\$ 156,900</u>
Loss from affiliated company:			
Simulation and Training Division	\$ (75,000)	\$ -	\$ -
Armor Division	-	-	-
Battery and Power Systems Division	-	-	-
	<u>\$ (75,000)</u>	<u>\$ -</u>	<u>\$ -</u>
Minority interest in loss (profit) of subsidiaries:			
Simulation and Training Division	\$ -	\$ -	\$ -
Armor Division	57,149	(44,694)	-
Battery and Power Systems Division	-	-	-
	<u>\$ 57,149</u>	<u>\$ (44,694)</u>	<u>\$ -</u>
Income (loss) from continuing operations:			
Simulation and Training Division	\$ 3,170,091	\$ 1,541,775	\$ 75,130
Armor Division	(15,678,786)	(222,485)	(299,559)
Battery and Power Systems Division	(869,178)	(661,166)	(612,760)
All Other	(10,545,538)	(9,700,437)	(8,510,842)
	<u>\$ (23,923,411)</u>	<u>\$ (9,042,313)</u>	<u>\$ (9,348,031)</u>
Loss from discontinued operations:			
Simulation and Training Division	\$ -	\$ -	\$ -
Armor Division	-	-	-
Battery and Power Systems Division	(120,000)	-	110,410
	<u>\$ (120,000)</u>	<u>\$ -</u>	<u>\$ 110,410</u>
Net income (loss):			
Simulation and Training Division	\$ 3,170,091	\$ 1,541,775	\$ 75,130
Armor Division	(15,678,786)	(222,485)	(299,559)
Battery and Power Systems Division	(989,178)	(661,166)	(502,350)
All Other	(10,545,538)	(9,700,437)	(8,510,842)
	<u><u>\$ (24,043,411)</u></u>	<u><u>\$ (9,042,313)</u></u>	<u><u>\$ (9,237,621)</u></u>

* Restated.

Three months ended June 30, 2006 compared to the three months ended June 30, 2005.

Revenues. During the three months ended June 30, 2006, we (through our subsidiaries) recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force training systems and from the provision of maintenance services in connection with such systems.

- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products.
- EFB and Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army.
- EFL recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for the three months ended June 30, 2006 totaled \$7.4 million, compared to \$12.2 million in the comparable period in 2005, a decrease of \$4.8 million, or 39.4%. This decrease was primarily attributable to the following factors:

- Decreased revenues from our Armor Division (\$3.9 million less in the three months ended June 30, 2006 versus the three months ended June 30, 2005).
- Decreased revenues from our Simulation and Training Division, particularly FAAC (\$1.0 million less in the three months ended June 30, 2006 versus the three months ended June 30, 2005).

In the second quarter of 2006, revenues were \$4.5 million for the Simulation and Training Division (compared to \$5.5 million in the second quarter of 2005, a decrease of \$1.0 million, or 18.4%, due primarily to decreased sales of FAAC); \$2.1 million for the Battery and Power Systems Division (compared to \$2.1 million in the second quarter of 2005, an increase of \$44,000, or 2.1%, due primarily to increased sales of Epsilon, offset to some extent by decreased CECOM revenues from our EFB subsidiary); and \$807,000 for the Armor Division (compared to \$4.7 million in the second quarter of 2005, a decrease of \$3.9 million, or 82.7%, due primarily to decreased revenues from MDT and AoA).

Cost of revenues and gross profit. Cost of revenues totaled \$6.1 million during the second quarter of 2006, compared to \$8.6 million in the second quarter of 2005, a decrease of \$2.5 million, or 29.3%, due primarily to decreased sales in our Simulation and Training Division and Armor Division and the decrease in margins due to change in the mix of products and customers in 2006 in comparison to 2005. In addition, we incurred substantial expenses in respect of production of a new product in our Armor Division.

Direct expenses for our three divisions during the second quarter of 2006 were \$4.2 million for the Simulation and Training Division (compared to \$5.0 million in the second quarter of 2005, a decrease of \$796,000, or 16.0%, due primarily to decreased sales of FAAC); \$2.1 million for the Battery and Power Systems Division (compared to \$2.3 million in the second quarter of 2005, a decrease of \$227,000, or 9.8%, due primarily to the decreased CECOM revenues from our EFB subsidiary); and \$1.8 million for the Armor Division (compared to \$4.4 million in the second quarter of 2005, a decrease of \$2.7 million, or 60.2%, due primarily to decreased revenues from MDT and AoA).

Gross profit was \$1.3 million during the second quarter of 2006, compared to \$3.6 million during the second quarter of 2005, a decrease of \$2.3 million, or 63.5%. This decrease was the direct result of all factors presented above, most notably the decrease in our Armor Division and Simulation and Training Division revenues and the decrease in margins due to change in the mix of products and customers in 2006 in comparison to 2005. In addition, we updated the accrual for loss for one of the projects in our Simulation and Training Division.

Research and development expenses. Research and development expenses for the second quarter of 2006 were \$216,000, compared to \$484,000 during the second quarter of 2005, a decrease of \$268,000, or 55.4%. This decrease was primarily attributable to the consolidation of IES's and FAAC's research and development operations, the decrease in research and development capitalization in FAAC and allocation of research and development costs in EFB to cost of good sold due to revenues from research and development projects.

Selling and marketing expenses. Selling and marketing expenses for the second quarter of 2006 were \$849,000, compared to \$1.1 million the second quarter of 2005, a decrease of \$215,000, or 20.2%. This decrease was primarily attributable to the overall decrease in revenues and their associated sales and marketing expenses.

General and administrative expenses. General and administrative expenses for the second quarter of 2006 were \$3.1 million compared to \$3.4 million in the second quarter of 2005, a decrease of \$226,000, or 6.7%. This decrease was primarily attributable to the following factors:

- Decreases in certain general and administrative expenses in comparison to 2005, such as auditing, legal expenses and travel expenses, as a result of cost-cutting programs implemented by management.
- Decrease in general and administrative expenses related to our Simulation and Training Division (payroll, legal and other expenses).

Financial expenses, net. Financial expenses totaled approximately \$5.0 million in the second quarter of 2006 compared to \$838,000 in the second quarter of 2005, an increase of \$4.2 million, or 496.7%. The difference was due primarily to interest related to our convertible notes that were issued in September 30, 2005, and financial expenses related to repayment by forced conversion of our convertible notes at an 8% discount to average market price as provided under the terms of the convertible notes.

Income taxes. We and certain of our subsidiaries incurred net operating losses during the three months ended June 30, 2006 and accordingly, no provision for income taxes was recorded. With respect to some of our subsidiaries that operated at a net profit during 2006, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of \$14,000 in tax expenses in the second quarter of 2006, compared to \$50,000 in tax expenses in the second quarter of 2005, mainly concerning state taxes.

Amortization of intangible assets. Amortization of intangible assets totaled \$460,000 in the second quarter of 2006, compared to \$823,000 in the second quarter of 2005, a decrease of \$363,000, or 44.1%, due primarily to a decrease in amortization of intangible assets related to our subsidiary AoA.

Impairment of goodwill and other intangible assets. Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units. We performed the required annual impairment test of goodwill, based on our management's projections and using expected future discounted operating cash flows. We did not identify any impairment of goodwill during the second quarter of 2006. In the corresponding period of 2005, we identified in AoA an impairment of goodwill in the amount of \$2,043,129.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with current accounting standards 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. We did not identify any impairment of backlog during the second quarter of 2006. In the corresponding period of 2005, we identified an impairment of backlog previously identified with the AoA acquisition and as a result we recorded an impairment loss in the amount of \$346,000.

Net loss. Due to the factors cited above, net loss attributable to common shareholders increased from \$5.6 million to \$8.2 million, an increase of \$2.6 million, or 46.1%.

Net loss attributable to common shareholders. Due to deemed dividend that was recorded in the amount of \$117,000 in the second quarter of 2006 due to the repricing of existing warrants and the issuance of new warrants, net loss attributable to common shareholders was \$8.3 million in the second quarter of 2006, compared to \$5.6 million in the second quarter of 2005, an increase of \$2.7 million, or 48.2%.

Six months ended June 30, 2006 compared to the six months ended June 30, 2005.

Revenues. During the six months ended June 30, 2006, we (through our subsidiaries) recognized revenues as follows:

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

Revenues for the six months ended June 30, 2006 totaled \$16.3 million, compared to \$22.6 million in the comparable period in 2005, a decrease of \$6.3 million, or 27.9%. This decrease was primarily attributable to the following factors:

- Decreased revenues from our Armor Division (\$5.2 million less in the first six months of 2006 versus the first six months of 2005).
- Decreased revenues from our Battery and Power Systems Division, particularly Epsilor (\$920,000 less in the first six months of 2006 versus the first six months of 2005).

In the six months ended June 30, 2006, revenues were \$9.4 million for the Simulation and Training Division (compared to \$9.6 million in the six months ended June 30, 2005, a decrease of \$194,000, or 2.0%, due primarily to decreased sales of IES, offset to some extent by increased revenues from FAAC); \$4.1 million for the Battery and Power Systems Division (compared to \$5.1 million in the six months ended June 30, 2005, a decrease of \$920,000, or 18.2%, due primarily to decreased sales of Epsilor and CECOM from our EFB subsidiary, offset to some extent by increased WAB revenues from our EFL subsidiary); and \$2.7 million for the Armor Division (compared to \$7.9 million in the six months ended June 30, 2005, a decrease of \$5.2 million, or 65.6%, due primarily to decreased revenues from MDT and AoA).

Cost of revenues and gross profit. Cost of revenues totaled \$12.7 million during the six months ended June 30, 2006, compared to \$15.0 million in the six months ended June 30, 2005, a decrease of \$2.2 million, or 14.9%, due primarily to decreased sales in our Battery and Power Systems division and Armor Division and the decrease in margins due to change in the mix of products and customers in 2006 in comparison to 2005. In addition, we incurred substantial expenses in respect of production of a new product in our Armor Division, and we updated our accrual for loss from one of our simulation projects.

Direct expenses for our three divisions during the six months ended June 30, 2006 were \$8.4 million for the Simulation and Training Division (compared to \$8.5 million in the six months ended June 30, 2005, a decrease of \$108,000, or 1.3%); \$4.2 million for the Battery and Power Systems Division (compared to \$5.1 million in the six months ended June 30, 2005, a decrease of \$832,000, or 16.4%, due primarily to decreased sales of Epsilor, offset to some extent by increased WAB revenues from our EFL subsidiary); and \$4.1 million for the Armor Division (compared to \$7.8 million in the six months ended June 30, 2005, a decrease of \$3.6 million, or 46.8%, due primarily to decreased revenues from MDT and AoA).

Gross profit was \$3.6 million during the six months ended June 30, 2006, compared to \$7.6 million during the six months ended June 30, 2005, a decrease of \$4.1 million, or 53.3%. This decrease was the direct result of all factors presented above, most notably the decrease in our Armor Division revenues, the decrease in our Battery and Power Systems Division revenue, the decrease in margins due to change in the mix of products and customers in 2006 in comparison to 2005 and the update of our accrual for loss from one of our simulation projects.

Research and development expenses. Research and development expenses for the six months ended June 30, 2006 were \$521,000, compared to \$899,000 during the six months ended June 30, 2005, a decrease of \$378,000, or 42.1%. This decrease was primarily attributable to the consolidation of IES's and FAAC's research and development operations, the decrease in research and development capitalization in FAAC and allocation of research and development costs in EFB to cost of good sold due to revenues from research and development projects.

Selling and marketing expenses. Selling and marketing expenses for the six months ended June 30, 2006 were \$1.7 million, compared to \$2.2 million the six months ended June 30, 2005, a decrease of \$475,000, or 21.4%. This decrease was primarily attributable to the overall decrease in revenues and their associated sales and marketing expenses.

General and administrative expenses. General and administrative expenses for the six months ended June 30, 2006 were \$6.2 million compared to \$6.7 million in the six months ended June 30, 2005, a decrease of \$480,000, or 7.1%. This decrease was primarily attributable to the following factors:

- Decreases in certain general and administrative expenses in comparison to 2005, such as auditing, legal expenses and travel expenses, as a result of cost-cutting programs implemented by management (\$366,000).
- Decrease in general and administrative expenses related to FAAC, primarily payroll, legal and other expenses (\$350,000).
- Decrease in general and administrative expenses related to IES as a result of the consolidation of IES and FAAC operations (\$106,000).
- Decrease in general and administrative expenses related to AoA due to decrease in operations, employees and the relocation of AoA to Alabama (\$248,000).

This decrease was offset to some extent by an increase in expenses related to the amortization of convertible debentures (\$659,000).

Financial expenses, net. Financial expenses totaled approximately \$6.5 million in the six months ended June 30, 2006 compared to \$1.3 million in the six months ended June 30, 2005, an increase of \$5.2 million, or 394.4%. The difference was due primarily to interest related to our convertible notes that were issued in September 30, 2005, and financial expenses related to repayment by forced conversion of our convertible notes at an 8% discount to average market price as provided under the terms of the convertible notes.

Income taxes. We and certain of our subsidiaries incurred net operating losses during the six months ended June 30, 2006 and, accordingly, no provision for income taxes was recorded. With respect to some of our subsidiaries that operated at a net profit during 2006, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of \$54,000 in tax expenses in the six months ended June 30, 2006, compared to \$267,000 in tax expenses in the six months ended June 30, 2005, mainly due to state taxes.

Amortization of intangible assets. Amortization of intangible assets totaled \$971,000 in the six months ended June 30, 2006, compared to \$1.6 million in the six months ended June 30, 2005, a decrease of \$675,000, or 41.0%, due primarily to a decrease in amortization of intangible assets related to our subsidiary AoA.

Impairment of goodwill and other intangible assets. Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units. We performed the required annual impairment test of goodwill, based on our management's projections and using expected future discounted operating cash flows. We did not identify any impairment of goodwill during the six months ended June 30, 2006. In the corresponding period of 2005, we identified in AoA an impairment of goodwill in the amount of \$2,043,129.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with current accounting standards 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. We did not identify any impairment of backlog during the six months ended June 30, 2006. In the corresponding period of 2005, we identified an impairment of backlog previously identified with the AoA acquisition and as a result we recorded an impairment loss in the amount of \$346,000.

Net loss. Due to the factors cited above, net loss attributable to common shareholders increased from \$8.1 million to \$12.4 million, an increase of \$4.3 million, or 53.8%.

Net loss attributable to common shareholders. Due to deemed dividend that was recorded in the amount of \$434,000 in the six months ended June 30, 2006 due to the repricing of existing warrants and the issuance of new warrants, net loss attributable to common shareholders was \$12.9 million in the six months ended June 30, 2006, compared to \$8.1 million in the six months ended June 30, 2005, an increase of \$4.8 million, or 59.2%.

Fiscal Year 2005 compared to Fiscal Year 2004

Revenues. During 2005, we recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force and driver operator training systems and from the provision of maintenance services in connection with such systems;
- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products;
- EFB and Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army; and
- EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase IV of the United States Department of Transportation (DOT) electric bus program.

Revenues for the year ended December 31, 2005 totaled \$49.0 million, compared to \$50.0 million for 2004, a decrease of \$909,000, or 2%. This decrease was primarily attributable to the decreased revenues of our Armor Division, specifically decreased revenues of MDT Armor (\$5.1 million during 2005 compared to \$13.4 million in 2004).

These decreased revenues were offset to some extent by increased revenues from our Simulation and Training Division (\$26.8 million in 2005 compared to \$21.5 million in 2004), due primarily to the increased revenues of FAAC.

In 2005, revenues were as follows:

- \$26.8 million for the Simulation and Training Division, compared to \$21.5 million in 2004, an increase of \$5.3 million, or 25%, due primarily to the increased revenues of FAAC (approximately \$4.5 million).
- \$12.3 million for the Armor Division, compared to \$18.0 million in 2004, a decrease of \$5.7 million, or 32%, due primarily to the decreased revenues from MDT Armor (approximately \$8.3 million) as a result of a slowdown in armoring orders related to the Iraq War. This decrease was partially offset by higher revenues recorded by us in 2005 from AoA in comparison to 2004, due to the fact that AoA's revenues were included for all of 2005 but only for the last five months of 2004. On a pro forma basis, AoA's revenues decreased in 2005 versus 2004, due to decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan, and, following Hurricane Katrina, the fact that substantial funds earmarked for defense were delayed to provide funds for hurricane relief.
- \$9.9 million for the Battery and Power Systems Division, compared to \$10.5 million in 2004, a decrease of \$585,000, or 6%, due primarily to decreased sales of lithium batteries and chargers by our Epsilon subsidiary as a result of reduced equipment purchases by one of its customers, offset to some extent by increased revenues from our Zinc-Air military batteries.

Cost of revenues and gross profit. Cost of revenues totaled \$34.4 million during 2005, compared to \$34.0 million in 2004, an increase of \$373,000, or 1%, due primarily to increased cost of goods sold related to the write off of inventory in the Armor Division in the amount of \$1.1 million in 2005.

Direct expenses for our three divisions during 2005 were \$22.0 million for the Simulation and Training Division, compared to \$17.9 million in 2004, an increase of \$4.1 million, or 23%, due primarily to the addition of expenses associated with increased sales of driver training systems through FAAC (approximately \$4.5 million), offset to some extent by decreased expenses associated with the sales of use-of-force training systems; \$14.0 million for the Armor Division, compared to \$16.4 million in 2004, a decrease of \$2.5 million, or 15%, due primarily to decreased revenues of MDT Armor (\$5.1 million during 2005 compared to \$13.4 million in 2004), offset to some extent by increased expenses associated with AoA, including inventory write-off; and \$9.8 million for the Battery and Power Systems Division, compared to \$10.0 million in 2004, a decrease of \$217,000, or 2%, due primarily to decreased revenues from Epsilon.

Gross profit was \$14.7 million during 2005, compared to \$15.9 million during 2004, a decrease of \$1.3 million, or 8%. This decrease was the direct result of all factors presented above, most notably the decrease in revenues and margins from MDT Armor and Epsilon and the inventory write-off in the amount of \$1.1 million in our Armor Division, offset to some extent by an increase in gross profit from our Simulation and Training Division.

Research and development expenses. Research and development expenses for 2005 were \$1.3 million, compared to \$1.7 million in 2004, a decrease of \$431,000, or 25%. This decrease was primarily attributable to allocating research and development expenses to the cost of revenues due to research and development contracts in the Battery and Power Systems Division and due to higher capitalization of software in the amount of \$286,000 in 2005 compared to 2004.

Sales and marketing expenses. Sales and marketing expenses for 2005 were \$4.5 million, compared to \$4.9 million in 2004, a decrease of \$451,000, or 9%. This decrease was primarily attributable to the decrease in sales commissions in the Battery and Power Systems Division.

General and administrative expenses. General and administrative expenses for 2005 were \$14.9 million, compared to \$10.7 million in 2004, an increase of \$4.2 million, or 39%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of AoA in our results for all of 2005 but only five months of 2004 (\$836,000);
- Increases in general and administrative expenses in our FAAC subsidiary due to legal expenses, employee relocation, accounting, incentive pay accruals, and similar expenses (\$809,000);
- Increase in other corporate general and administrative expenses such as auditing, legal and travel expenses (\$800,000); and
- Increase in costs related to abandoned acquisition activities (\$1.1 million).

Financial expenses, net. Financial expense, net of interest income and exchange differentials, totaled approximately \$2.7 million in 2005, compared to \$4.2 million in 2004, a decrease of \$1.5 million, or 36%. This decrease was due primarily to the decreased amortization of compensation related to warrants issued to the holders of convertible debentures and related beneficial conversion feature.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2005 and, accordingly, we were not required to make any provision for income taxes. With respect to some of our subsidiaries that operated at a net profit during 2005, we were able to offset federal taxes against our net operating loss carry forwards. We recorded a total of \$238,000 in tax expenses in 2005, with respect to certain of our subsidiaries that operated at a net profit during 2005 and we are not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes. We recorded a total of \$586,000 in tax expenses in 2004, with respect to certain of our subsidiaries that operated at a net profit during 2004 and we were not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes.

Amortization of intangible assets. Amortization of intangible assets totaled \$3.1 million in 2005, compared to \$2.5 million in 2004, an increase of \$576,000, or 23%, due primarily to amortization of intangible assets related to our AoA subsidiary that we acquired in August 2004.

Impairment of goodwill and other intangibles assets. Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units.

During 2005, we performed an impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows, as a response to several factors, including without limitation the reduced sales in AoA (a component of our Armor Division), the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA us, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular - specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), and the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, substantial funds earmarked for defense were delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, we identified in AoA an impairment of goodwill in the amount of \$11.8 million.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with current accounting standards 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. As of December 31, 2004, we identified an impairment of the technology previously purchased from Bristlecone and, as a result, we recorded an impairment loss in the amount of \$320,000. As of December 31, 2005, we identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$499,000.

Loss from continuing operations. Due to the factors cited above, we reported a loss from continuing operations of \$23.9 million in 2005, compared to \$9.0 million in 2004, an increase of \$14.9 million, or 165%.

Loss from discontinued operations. Net loss from discontinued operations for 2005 was \$120,000 compared to \$0 in 2004. This is because during the second quarter of 2005 we took an accrual of \$200,000 for a litigation contingency related to the discontinued operations; in March 2006, this litigation was settled for \$120,000.

Net loss before deemed dividend of common stock to certain stockholders. Due to the factors cited above, we reported a net loss of \$24.0 million in 2005, compared to a net loss of \$9.0 million in 2004, an increase of \$15.0 million, or 166%.

Net loss after deemed dividend of common stock to certain stockholders. In 2004 we had a deemed dividend of \$3.3 million (see Notes 13.f.3. and 13.f.4. to the financial statements) that we did not have in 2005. Accordingly, net loss after deemed dividend of common stock to certain stockholders was \$24.0 million in 2005, compared to \$12.4 million in 2004, an increase of \$11.7 million, or 94%.

Fiscal Year 2004 compared to Fiscal Year 2003

Revenues. During 2004, we recognized revenues as follows:

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

Revenues from continuing operations for the year ended December 31, 2004 totaled \$50.0 million, compared to \$17.3 million for 2003, an increase of \$32.6 million, or 188%. This increase was primarily attributable to the following factors:

- Increased revenues from vehicle armoring; and
- Revenues generated by FAAC, Epsilon and AoA in 2004 that were not present in 2003.

These increases were offset to some extent by decreased revenues from sales of interactive use-of-force training systems and decreased revenues from sales of our Zinc-Air military batteries.

In 2004, revenues were \$21.5 million for the Simulation and Training Division (compared to \$8.0 million in 2003, an increase of \$13.4 million, or 168%, due primarily to the added revenues from sales of driver training systems since we acquired FAAC (approximately \$16.5 million), offset to some extent by decreased revenues from use-of-force training systems); \$18.0 million for the Armor Division (compared to \$3.4 million in 2003, an increase of \$14.6 million, or 424%, due primarily to increased revenues from vehicle armoring and to the added revenues from aircraft armoring since we acquired AoA); and \$10.5 million for the Battery and Power Systems Division (compared to \$5.9 million in 2003, an increase of \$4.6 million, or 79%, due primarily to the added revenues from sales of lithium batteries and chargers since we acquired Epsilon (approximately \$5.3 million), offset to some extent by decreased revenues from our Zinc-Air military batteries).

Cost of revenues and gross profit. Cost of revenues totaled \$34.0 million during 2004, compared to \$11.1 million in 2003, an increase of \$22.9 million, or 207%, due to increased cost of goods sold, particularly in the Armor Division (partly as a result of our beginning to sell pre-armored vehicles in 2004, which requires us to purchase vehicles for pre-armoring) and in the Simulation and Training Division, as well as the inclusion of the cost of goods of FAAC, Epsilon and AoA in our results for 2004 but not 2003.

Direct expenses for our three divisions during 2004 were \$17.9 million for the Simulation and Training Division (compared to \$7.3 million in 2003, an increase of \$10.6 million, or 145%, due primarily to the addition of expenses associated with sales of driver training systems through FAAC (approximately \$12.0 million), offset to some extent by decreased expenses associated with the sales of use-of-force training systems); \$16.4 million for the Armor Division (compared to \$3.6 million in 2003, an increase of \$12.9 million, or 359%, due primarily to increased expenses associated with sales of vehicle armoring (a \$12.1 million increase in 2004, including the expenses of purchasing vehicles for pre-armoring in 2004, which was not present in 2003), and to the addition beginning in August 2004 of expenses associated with sales of aircraft armoring through our new subsidiary AoA); and \$10.0 million for the Battery and Power Systems Division (compared to \$5.9 million in 2003, an increase of \$4.0 million, or 68%, due primarily to the addition of expenses associated with sales of lithium batteries and chargers through our new Epsilon subsidiary (\$4.2 million), offset to some extent by decreased expenses associated with the sales of Zinc-Air military batteries).

Gross profit was \$15.9 million during 2004, compared to \$6.2 million during 2003, an increase of \$9.7 million, or 155%. This increase was the direct result of all factors presented above, most notably the inclusion of FAAC, Epsilon and AoA in our results for 2004 (\$10.2 million), as well as the increased revenues from vehicle armoring (\$1.6 million), offset to some extent by a decrease of \$2.0 million in gross profit from IES.

Research and development expenses. Research and development expenses for 2004 were \$1.7 million, compared to \$1.1 million in 2003, an increase of \$678,000, or 64%. This increase was primarily the result of the inclusion of the research and development expenses of FAAC, Epsilon and AoA in our results in 2004 (\$533,000) and increased research and development expenses of EFL and EFB.

Sales and marketing expenses. Sales and marketing expenses for 2004 were \$4.9 million, compared to \$3.5 million in 2003, an increase of \$1.4 million, or 39%. This increase was primarily attributable to the inclusion of the sales and marketing expenses of FAAC, Epsilon and AoA in our results for 2004 (\$2.0 million), offset to some extent by a decrease of \$600,000 in expenses related to our military batteries and a decrease in sales and marketing expenses related to interactive use-of-force training.

General and administrative expenses. General and administrative expenses for 2004 were \$10.7 million, compared to \$5.9 million in 2003, an increase of \$4.8 million, or 82%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of FAAC, Epsilor and AoA in our results for 2004 (\$2.4 million);
- Expenses in 2004 in connection with grant of options and shares to employees that were not present in 2003 (\$830,000);
- Costs associated with our compliance with Section 404 of the Sarbanes-Oxley Act of 2002 that were not present in 2003 (\$150,000); and
- Increases in other general and administrative expenses, such as employee salaries and bonuses, travel expenses, audit fees, director fees, legal fees, and expenses related to due diligence performed in connection with certain potential acquisitions, which were not present in 2003.

We are not anticipating a reduction in our general and administrative expenses in the coming year, and we expect that our travel expenses, audit fees, legal fees, and due diligence expenses will continue or increase to the extent that we continue to pursue acquisitions in the future.

These increases were offset to some extent by:

- Expenses in 2003 in connection with a litigation settlement agreement that were not present in 2004 (\$700,000); and
- Amortization of legal and consulting expenses in 2003 in connection with our convertible debentures that were lower (by \$260,000) than in 2004.

Financial expenses, net. Financial expense, net of interest income and exchange differentials, totaled approximately \$4.2 million in 2004 compared to \$4.0 million in 2003, an increase of \$190,000, or 5%. This difference was due primarily to amortization of debt discount related to the issuance of convertible debentures and their conversion, as well as interest expenses related to those debentures.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2004 and, accordingly, we were not required to make any provision for income taxes. With respect to some of our subsidiaries that operated at a net profit during 2004, we were able to offset federal taxes against our net operating loss carry forwards. We recorded a total of \$586,000 in tax expenses in 2004, with respect to certain of our subsidiaries that operated at a net profit during 2004 and we are not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes. In 2003, tax expenses were recorded with respect to MDT's taxable income. Out of the \$586,000 tax expense that we recorded in 2004, \$84,000 was related to prior years and \$(37,000) represented income from deferred taxes, net.

Amortization of intangible assets and impairment. Amortization of intangible assets totaled \$2.8 million in 2004, compared to \$865,000 in 2003, an increase of \$1.9 million, or 225%, resulting from the inclusion of the amortization of the intangible assets of FAAC, Epsilor and AoA in our results in 2004 and impairment in the amount of \$320,000 of technology previously purchased by IES from Bristlecone Technologies.

Net loss before deemed dividend of common stock to certain stockholders. Due to the factors cited above, we reported a net loss of \$9.0 million in 2004, compared to a net loss of \$9.2 million in 2003, a decrease of \$195,000, or 2%.

Net loss after deemed dividend of common stock to certain stockholders was \$12.4 million due to a deemed dividend of \$3.3 million (see Notes 13.f.3. and 13.f.4. to the financial statements) compared to \$9.6 million in 2003, an increase of 2.8 million, or 29%.

Fiscal Year 2003 compared to Fiscal Year 2002

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

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

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

In 2003, revenues were \$8.0 million for the Simulation and Security Division (compared to \$2.0 million in 2002, an increase of \$6.0 million, or 305%, due primarily to the inclusion of IES in our results for the full year of 2003 but only part of 2002), \$5.9 million for the Battery and Power Systems Division (compared to \$1.7 million in the comparable period in 2002, an increase of \$4.2 million, or 249%, due primarily to increased sales to the U.S. Army on the part of EFB), and \$3.4 million for the Armor Division (compared to \$2.7 million in 2002, an increase of \$691,000, or 25%, due primarily to the inclusion of MDT in our results for the full year of 2003 but only part of 2002).

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

Direct expenses for our three divisions during 2003 were \$7.3 million for the Simulation and Security Division (compared to \$2.0 million in 2002, an increase of \$5.3 million, or 259%, due primarily to increased sales attributable to the inclusion of IES in our results for the full year of 2003 but only part of 2002), \$5.9 million for the Battery and Power Systems Division (compared to \$3.1 million in the comparable period in 2002, an increase of \$2.9 million, or 94%, due primarily to increased sales on the part of EFB to the U.S. Army), and \$3.6 million for the Armor Division (compared to \$2.3 million in 2002, an increase of \$1.3 million, or 55%, due primarily to the inclusion of MDT in our results for the full year of 2003 but only part of 2002).

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

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

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

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

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

- The inclusion of the general and administrative expenses of IES and MDT in our results for the full year of 2003 but only part of 2002;
- Expenses in 2003 in connection with a litigation settlement agreement, in the amount of \$714,000, that were not present in 2002;
- Expenses in 2003 in connection with warrant grants, in the amount of \$199,500, that were not present in 2002;
- Legal and consulting expenses in 2003 in connection with our convertible debentures, in the amount of \$484,000, that were not present in 2002; and
- Expenses in 2003 in connection with the start-up of our security consulting business in the United States and with the beginning of operations of MDT Armor, in the amount of \$250,000, that were not present in 2002.

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

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

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

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

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

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

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

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

Liquidity and Capital Resources

As of June 30, 2006, we had \$4.6 million in cash, \$8.3 million in restricted collateral securities and cash deposits due within one year, \$22,000 in long-term restricted securities and deposits, and \$38,000 in available-for-sale marketable securities, as compared to at December 31, 2005, when we had \$6.2 million in cash, \$3.9 million in restricted collateral securities and restricted held-to-maturity securities due within one year, \$779,000 in long-term restricted deposits, and \$36,000 in available-for-sale marketable securities. The increase in restricted collateral securities and cash deposits was primarily the result of warrant exercises in February, March and April of 2006 (see Note 6 to the financial statements).

We used available funds in the six months ended June 30, 2006 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets during the six months ended June 30, 2006 by \$493,000 over the investment as at December 31, 2005, primarily in the Battery and Power Systems and Armor Divisions. Our net fixed assets amounted to \$4.0 million at quarter end.

Net cash used in operating activities from continuing operations for the six months ended June 30, 2006 and 2005 was \$2.0 million and \$3.9 million, respectively, a decrease of \$1.9 million. This decrease was primarily the result of a decrease in trade receivables in comparison to the six months ended June 30, 2005 offset by a decrease in trade payables in 2005 in comparison to the six months ended June 30, 2006.

Net cash used in investing activities for the six months ended June 30, 2006 and 2005 was \$4.9 million and \$1.0 million, an increase of \$3.9 million. This increase was primarily the result of warrant exercises during the six months ended June 30, 2006, the proceeds of which were deposited in restricted accounts for the payment of our convertible debentures due in September 2006, resulting in an increase in restricted securities and deposits.

Net cash provided by (used in) financing activities for the three months ended June 30, 2006 and 2005 was \$5.4 million and \$2.4 million, respectively. This increase was primarily the result of warrant exercises in February, March and April of 2006.

As of December 31, 2005, we had \$6.2 million in cash, \$3.9 million in restricted collateral securities and restricted held-to-maturity securities due within one year, \$779,000 in long-term restricted deposits, and \$36,000 in available-for-sale marketable securities, as compared to at December 31, 2004, when we had \$6.7 million in cash, \$7.0 million in restricted collateral securities and restricted held-to-maturity securities due within one year, \$4.0 million in long-term restricted deposits, and \$136,000 in available-for-sale marketable securities.

We used available funds in 2005 primarily for sales and marketing, continued research and development expenditures, expenses in connection with acquisitions and proposed acquisitions, and other working capital needs. We increased our investment in fixed assets by \$1.2 million during the year ended December 31, 2005, primarily in the Battery and Power Systems Division and in the Simulation and Training Division. Our net fixed assets amounted to \$4.3 million as at year end.

Net cash used in operating activities for 2005 and 2004 was \$11.8 million and \$852,000, respectively, an increase of \$10.2 million. This increase was primarily the result of increased loss in 2005 and an increase in trade receivables and decrease in trade payables and other account payables.

Net cash used in investing activities for 2005 and 2004 was \$11.8 million and \$50.5 million, respectively, a decrease of \$38.7 million. This decrease was primarily the result of our investment in the acquisition of FAAC, Epsilor and AoA in 2004.

Net cash provided by financing activities for 2005 and 2004 was \$22.2 million and \$44.4 million, respectively, a decrease of \$22.1 million. This decrease was primarily the result of lower amounts of funds raised through sales of our securities in 2005 compared to 2004.

During 2005, certain of our employees exercised options under our registered employee stock option plan. The proceeds to us from the exercised options were approximately \$17,000.

As of June 30, 2006, we had (based on the contractual amount of the debt and not on the accounting valuation of the debt, not taking into consideration trade payables, other accounts payables and accrued severance pay) approximately \$1.1 million in long term bank and certificated debt outstanding, all of which was convertible debt, and approximately \$15.1 million in short-term debt (which included short-term bank credit and convertible debentures in an amount of \$11.8 million, and liability due to acquisition of subsidiary in the amount of \$208,000).

Based on our internal forecasts, which are 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, lines of credit and anticipated additions to paid-in capital should be sufficient to satisfy our current estimated cash requirements through the remainder of the year. This belief is based on certain earnout and other assumptions that our management and our subsidiaries managers believe to be reasonable, some of which are subject to the risk factors detailed under “Risk Factors” in Item IA of Part II, below, including without limitation (i) that we will be able to refinance, restructure or convert to equity our \$10.3 million in convertible debt (debentures and notes) that is due in 2006 (which does not include \$3.1 million short-term bank credit), (ii) that the severance and retirement benefits that we owe to certain of our senior executives will not have to be paid ahead of their anticipated schedule, and (iii) that no other earnout payments to the former shareholder of AoA will be required in excess of the funds being held by him in escrow to secure such earnout obligations. In this connection, we note that we can require the holders of our senior secured convertible notes to convert a portion of their notes into shares of our common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. We do not have shares of our stock registered for resale in order to continue requiring the holders to convert a portion of their notes. We have accordingly filed this registration statement with the SEC to register for resale more shares of our common stock in order to continue requiring conversion of our notes upon principal payment becoming due. Any delay in the registration process, including through routine SEC review of our registration statement or other filings with the SEC, could result in our having to pay scheduled principal repayments on our notes in cash, which would negatively impact our cash position and, if we do not have sufficient cash to make such payments in cash, could cause us to default on our notes. We also note that from time to time our working capital needs are partially dependent on our subsidiaries’ lines of credit. In the event that we are unable to continue to make use of our subsidiaries’ lines of credit for working capital on economically feasible terms, our business, operating results and financial condition could be adversely affected.

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

Effective Corporate Tax Rate

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2005, 2004 and 2003, and accordingly no provision for income taxes was required. With respect to some of our U.S. subsidiaries that operated at a net profit during 2005, we were able to offset federal taxes against our net operating loss carryforward, which amounted to \$26.0 million as of December 31, 2005. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. With respect to certain of our Israeli subsidiaries that operated at a net profit during 2005, we were unable to offset their taxes against our net operating loss carryforward, and we are therefore exposed to Israeli taxes, at a rate of up to 34% in 2005 (less, in the case of companies that have “approved enterprise” status as discussed in Note 14 to the Notes to Financial Statements).

As of December 31, 2005, we had a U.S. net operating loss carryforward of approximately \$26.0 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2009 through 2025, and foreign net operating and capital loss carryforwards of approximately \$82.0 million, which are available indefinitely to offset future taxable income under certain circumstances.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2005, not including trade payables and other accounts payable:

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt*	\$ 8,750,000	\$ -	\$ 8,750,000	\$ -	\$ -
Short-term debt**	\$ 15,474,448	\$ 15,474,448	\$ -	\$ -	\$ -
Operating lease obligations***	\$ 1,926,383	\$ 826,367	\$ 1,003,176	\$ 96,840	\$ -
Severance obligations****	\$ 1,732,955	\$ 137,685	\$ 1,595,269	\$ -	\$ -

* Includes convertible debentures in the gross amount of \$8,750,000. Unamortized financial expenses related to the beneficial conversion feature of these convertible debentures amounted to \$160,000 at year end.

** Includes sums owed in respect of an earn-out provision related to our acquisition of FAAC, in the amount of \$604,000. Also includes \$12.8 million short-term convertible note and \$2.0 million in short-term bank debt

*** Includes operating lease obligations related to rent.

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

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

It is our policy not to enter into interest rate derivative financial instruments, except for hedging of foreign currency exposures. We do not currently have any significant interest rate exposure.

Foreign Currency Exchange Rate Risk

Since a significant part of our sales and expenses are denominated in U.S. dollars, we have experienced only insignificant foreign exchange gains and losses to date, and do not expect to incur significant foreign exchange gains and losses in 2006. Our research,

development and production activities are primarily carried out by our Israeli subsidiary, EFL, at its facility in Beit Shemesh, and accordingly we have sales and expenses in New Israeli Shekels. Additionally, our MDT and Epsilor subsidiaries operate primarily in New Israeli Shekels. However, the majority of our sales are made outside Israel in U.S. dollars, and a substantial portion of our costs are incurred in U.S. dollars. Therefore, our functional currency is the U.S. dollar. Please see Note 2.b. to the Notes to the Consolidated Financial Statements.

DIRECTORS AND EXECUTIVE OFFICERS

Executive Officers, Directors and Significant Employees

Executive Officers and Directors

Our executive officers and directors and their ages as of February 28, 2006 were as follows:

Name	Age	Position
Robert S. Ehrlich	67	Chairman of the Board and Chief Executive Officer
Steven Esses	42	President, Chief Operating Officer and Director
Thomas J. Paup	57	Vice President - Finance and Chief Financial Officer
Dr. Jay M. Eastman	57	Director
Jack E. Rosenfeld	67	Director
Lawrence M. Miller	59	Director
Edward J. Borey	55	Director
Seymour Jones	74	Director

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 Mr. Esses are designated Class I directors and have been elected for a term expiring in 2006 and until their successors are elected and qualified; Messrs. Rosenfeld, Miller and Jones are designated Class II directors elected for a term expiring in 2008 and until their successors are elected and qualified; and Messrs. Ehrlich and Borey are designated Class III directors elected for a term that expires in 2007 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 President and Chief Executive Officer since October 2002. In December 2006 Mr. Ehrlich ceased to hold the title of President. From May 1991 until January 1993, Mr. Ehrlich was our Vice Chairman of the Board, and from May 1991 until October 2002 he was our Chief Financial Officer. Mr. Ehrlich was a director of Eldat, Ltd., an Israeli manufacturer of electronic shelf labels, from June 1999 to July 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. PSCX filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in November 2002. Mr. Ehrlich received a B.S. and J.D. from Columbia University in New York, New York.

Steven Esses has been a director since July 2002, our Executive Vice President since January 2003, our Chief Operating Officer since February 2003 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. From 1995 to 2000, Mr. Esses founded Dunkin’ Donuts in Israel and held the position of Managing Director and CEO. Prior thereto, he was 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.

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 the Company, 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.

Dr. Jay M. Eastman has been one of our directors since October 1993. Since November 1991, Dr. Eastman has served as President and Chief Executive Officer of Lucid, Inc., which is developing laser technology applications for medical diagnosis and treatment. 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 January 1983, Dr. Eastman was Director of the University of Rochester's Laboratory for Laser Energetics, where he was a member of the staff from September 1975 to 1981. Dr. Eastman holds a B.S. and a Ph.D. in Optics from the University of Rochester in New York.

Jack E. Rosenfeld has been one of our directors since October 1993. Mr. Rosenfeld was President and Chief Executive Officer of Potpourri Group Inc. ("Potpourri"), a specialty catalog direct marketer, from April 1998 until June 2003; from June 2003 until February 2005, Mr. Rosenfeld served as Chairman of Potpourri's Board of Directors and as its CEO, and since February 2005, Mr. Rosenfeld has been Executive Chairman of the Potpourri Board of Directors. Mr. Rosenfeld was President and Chief Executive Officer of Hanover Direct, Inc., formerly Horn & Hardart Co., which operates a direct mail marketing business, from September 1990 until December 1995, and had been President and Chief Executive Officer of its direct marketing subsidiary, from May 1988 until September 1990. Mr. Rosenfeld holds a B.A. from Cornell University in Ithaca, New York and an LL.B. from Harvard University in Cambridge, Massachusetts.

Lawrence M. Miller was elected to the board of directors in November 1996. Mr. Miller has been a senior partner in the Washington D.C. law firm of Schwartz, Woods and Miller since 1990. He served from August 1993 through May 1996 as a member of the board of directors of The Phoenix Resource Companies, Inc., a publicly traded energy exploration and production company, and as a member of the Audit and Compensation Committee of that board. That company was merged into Apache Corporation in May 1996. Mr. Miller holds a B.A. from Dickinson College in Carlisle, Pennsylvania and a J.D. with honors from George Washington University in Washington, D.C. He is a member of the District of Columbia bar.

Edward J. Borey has served as a director since December 2003. Mr. Borey has been Chairman and Chief Executive Officer of WatchGuard Technologies, Inc., a leading provider of network security solutions (NasdaqNM: WGRD), since July 2004. From December 2000 to September 2003, Mr. Borey served as President, Chief Executive Officer and a director of PSCX. PSCX filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in November 2002. 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. Currently, Mr. Borey serves as a Board member at Mbrane (formerly known as Centura Software), and he is on the Advisory Board of TranSenda Software and NextRx. 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.

Seymour Jones has served as a director since July 2005. Mr. Jones is a clinical professor of accounting at New York University Stern School of Business. Professor Jones teaches courses in auditing, tax and legal aspects of entrepreneurship. He is also the Associate Director of Ross Institute of Accounting Research at Stern School of Business. Professor Jones has been with NYU Stern for ten years. His primary research areas include audit committees, auditing, entrepreneurship, financial reporting, and fraud. Professor Jones has been principal author of numerous books including *Conflict of Interest*, *The Cooper & Lybrand Guide to Growing Your Business*, *The Emerging Business* and *The Bankers Guide to Audit Reports and Financial Statements*. Before joining NYU Stern, Professor Jones was senior partner at Coopers & Lybrand and S.D. Leidesdorf & Co. 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.

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. The Audit Committee consists of Prof. Jones (Chair) and Messrs. Miller and Rosenfeld. We have determined that Prof. Jones qualifies as an “audit committee financial expert” under applicable SEC and Nasdaq regulations. Prof. Jones, as well as all the other members of the Audit Committee, is “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 Securities Exchange Act of 1934.

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 consists of Dr. Eastman (Chair) and Messrs. Rosenfeld and Borey, 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), Miller, Borey and Esses.

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. Rosenfeld (Chair), Mr. Miller and Dr. Eastman, 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 Securities Exchange Act of 1934. The Nominating Committee operates under a formal charter that governs its duties.

Director Compensation

Non-employee members of our board of directors are paid \$2,500 (plus expenses) for each board of directors meeting attended, \$2,000 (plus expenses) for each meeting of the audit committee of the board of directors attended, and \$1,000 (plus expenses) for each meeting of all other committees of the board of directors attended. In addition, we have adopted a Non-Employee Director Stock Option Plan pursuant to which non-employee directors receive an initial grant of options to purchase 2,857 shares of our common stock upon the effective date of such plan or upon the date of his or her election as a director. Thereafter, non-employee directors will receive options to purchase 1,786 shares of our common stock for each year of service on the board. All such options are granted at fair market value and vest ratably over three years from the date of the grant. During 2005, our directors agreed to an interim reduction in their fees of 25% as part of our overall cost-cutting strategy.

EXECUTIVE COMPENSATION

Cash and Other Compensation

General

Our Chief Executive Officer and the other highest paid executive officers (of which there were two) who were compensated at a rate of more than \$100,000 in salary and bonuses during the year ended December 31, 2005 (collectively, the “Named Executive Officers”) are Israeli residents, and thus certain elements of the compensation that we pay them is structured as is customary in Israel.

During 2005, 2004 and 2003, compensation to our Named Executive Officers took several forms:

- cash salary;
- bonus, some of which was paid in cash in the year in which it was earned and some of which was accrued in the year in which it was earned but paid in cash in a subsequent year;
- cash reimbursement for taxes paid by the Named Executive Officer and reimbursed by us in accordance with Israeli tax regulations;
- accruals (but not cash payments) in respect of contractual termination com-pen-sa-tion in excess of the Israeli statutory minimum;
- accruals (but not cash payments) in respect of pension plans, which consist of a savings plan, life insurance and statutory severance pay benefits, and a continuing education fund (as is customary in Israel);
- stock options;
- grants of restricted stock, where the sale of such stock is prohibited for a period of two years and such stock is forfeit to us should the Named Executive Officer’s employment be terminated for cause, as defined in such Executive’s employment agreement (*e.g.*, fraud, reckless or willful misconduct, etc.); and
- other benefits, primarily consisting of annual statutory holiday pay and redemption of unused vacation days and sick days.

The specific amounts of each form of compensation paid to each Named Executive Officer appear in the summary compensation table and the notes thereto appearing under “Summary Compensation Table,” below.

Summary Compensation Table

The following table, which should be read in conjunction with the explanations provided above, shows the compensation that we paid (or accrued), in connection with services rendered for 2005, 2004 and 2003, to our Named Executive Officers.

SUMMARY COMPENSATION TABLE⁽¹⁾

Name and Principal Position	Year	Annual Compensation			Long Term Compensation	All Other Compensation			
		Salary	Bonus	Tax Reimbursement	Awards		Changes in Accruals for Sick Days, Vacation Days, and Termination Compensation	Payment to Pension and Education Funds	Others
					Restricted Stock Awards (2)	Securities Underlying Options			
Robert S. Ehrlich	2005	\$ 275,362	\$ 49,875	\$ 26,340	\$ 0	0(3)	\$ (51,363(4)	\$ 45,362	\$112,413(5)
Chairman of the Board	2004	\$ 275,907	\$ 175,000	\$ 29,103	\$ 626,350	3,571	\$ 133,898(6)	\$ 548,477(7)	\$ 19,893
Chief Executive Officer and director*	2003	\$ 259,989	\$ 180,000(8)	\$ 27,211	\$ 0	145,357	\$ 80,713(9)	\$ 48,228	\$ 678
Steven Esses	2005	\$ 56,722(10)	\$ 112,000(11)	\$ 22,666	\$ 0	8,204(12)	\$ 228,403(13)	\$ 12,446	\$ 13,607
President, Chief Operating	2004	\$ 65,506(14)	\$ 106,000(15)	\$ 25,273	\$ 221,100	0	\$ 3,759(16)	\$ 12,116	\$ 12,940
Officer and director**	2003	\$ 0	\$ 0	\$ 0	\$ 0	73,929	\$ 0	\$ 0	\$ 0
Avihai Shen	2005	\$ 157,013	\$ 0	\$ 7,889	\$ 0	0	\$ 70,479(17)	\$ 23,121	\$ 39,476(18)
Vice President - Finance and	2004	\$ 155,845	\$ 97,000	\$ 6,407	\$ 54,900	1,339	\$ 34,972(19)	\$ 26,889	\$ 476
Chief Financial Officer***	2003	\$ 123,988	\$ 0	\$ 8,653	\$ 0	43,482	\$ 6,471(20)	\$ 23,133	\$ 463

* Mr. Ehrlich ceased to hold the title of President in December 2005.

** Mr. Esses became an executive officer in January 2003. His compensation as an officer during 2003 consisted solely of stock options. In December 2005, Mr. Esses became our President; prior thereto, he held the title of Executive Vice President.

*** Mr. Shen ceased to act as our Chief Financial Officer in February 2006, and his employment with us terminated on March 31, 2006.

⁽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.

⁽²⁾ Based on the closing market price of our stock on the Nasdaq Stock Exchange on the date of grant multiplied by the number of shares awarded. As of December 31, 2004, our Named Executive Officers held 45,357 restricted shares. Of these shares, the restrictions on 37,857 shares are scheduled to expire on August 4, 2006, and the restrictions on 7,500 are scheduled to expire on December 8, 2006. The value of the restricted shares held by our Named Executive Officers on December 31, 2004, based on the closing price of our stock on the Nasdaq Stock Exchange on that date, was \$902,350.

⁽³⁾ During 2005, no new options were granted to Mr. Ehrlich; however, 42,857 of Mr. Ehrlich's options were repriced in 2005 from an average exercise price of \$16.66 to a new exercise price of \$5.46. Additionally, 56,012 of Mr. Ehrlich's options expired or were cancelled during 2005.

⁽⁴⁾ Of this amount, \$67,024 represents 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; \$(51,928) represents the decrease of the accrual for vacation days redeemable by Mr. Ehrlich; \$(40,483) represents the decrease of the accrual for sick days redeemable by Mr. Ehrlich; and \$(25,976) represents the decrease of our accrual for severance pay that would be payable to Mr. Ehrlich under the laws of the State of Israel if we were to terminate his employment.

⁽⁵⁾ Of this amount, \$61,195 represents payment for redemption of accrued but unused vacation days, and \$33,394 represents payment for redemption of accrued but unused sick days.

- ⁽⁶⁾ Of this amount, \$76,766 represents our accrual for severance pay that would be payable to Mr. Ehrlich upon a “change of control” or upon the occurrence of certain other events; \$28,603 represents the increase of the accrual for vacation days redeemable by Mr. Ehrlich; and \$28,529 represents the increase of our accrual for severance pay that would be payable to Mr. Ehrlich under the laws of the State of Israel if we were to terminate his employment.
- ⁽⁷⁾ Of this amount, \$500,000 was deposited by us in a Rabbi Trust for Mr. Ehrlich’s benefit. Pursuant to the terms of the Rabbi Trust, funds in the Rabbi Trust continue to be owned by us, and benefit from all gains and bear the risk of all losses resulting from investments of Rabbi Trust funds. See “Employment Contracts - Robert S. Ehrlich,” below.
- ⁽⁸⁾ We paid Mr. Ehrlich \$180,000 during 2004 in satisfaction of his bonus from 2003 to which he was entitled according to his contract. Of this amount, we accrued \$99,750 for Mr. Ehrlich in satisfaction of the 2003 bonus to which he was entitled according to his contract; the remainder was the result of the approval in 2004 by the Compensation Committee of a higher bonus for 2003 than Mr. Ehrlich’s contractual minimum.
- ⁽⁹⁾ Of this amount, \$92,075 represents our accrual for severance pay that would be payable to Mr. Ehrlich upon a “change of control” or upon the occurrence of certain other events; \$3,451 represents the increase of the accrual for sick leave and vacation days redeemable by Mr. Ehrlich; and \$(14,813) represents the decrease of our accrual for severance pay that would be payable to Mr. Ehrlich under the laws of the State of Israel if we were to terminate his employment.

- ⁽¹⁰⁾ Does not include \$178,176 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 "Certain Relationships and Related Transactions - Consulting Agreement with Sampen Corporation," below.
- ⁽¹¹⁾ Includes a \$100,000 signing bonus that was paid to Mr. Esses in 2005 and the \$12,000 minimum bonus to which Mr. Esses is entitled pursuant to the terms of his employment contract. Does not include \$30,720 that we paid as a bonus to Sampen Corporation, a New York corporation owned by members of Steven Esses's immediate family, from which Mr. Esses receives a salary. See "Certain Relationships and Related Transactions - Consulting Agreement with Sampen Corporation," below..
- ⁽¹²⁾ In addition to the grant of 8,204 new options during 2005, 63,224 of Mr. Esses's options were repriced in 2005 from an average exercise price of \$11.20 to a new exercise price of \$5.46.
- ⁽¹³⁾ Of this amount, \$186,707 represents the increase of our accrual for severance pay that would be payable to Mr. Esses if we were to terminate his employment; and \$41,369 represents the increase of the accrual for sick leave and vacation days redeemable by Mr. Esses.
- ⁽¹⁴⁾ Does not include \$208,100 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 "Certain Relationships and Related Transactions - Consulting Agreement with Sampen Corporation," below.
- ⁽¹⁵⁾ Does not include \$110,000 that we paid as a bonus to Sampen Corporation, a New York corporation owned by members of Steven Esses's immediate family, from which Mr. Esses receives a salary. See "Certain Relationships and Related Transactions - Consulting Agreement with Sampen Corporation," below.
- ⁽¹⁶⁾ Represents the increase of the accrual for vacation days redeemable by Mr. Esses.
- ⁽¹⁷⁾ Of this amount, \$104,602 represents the increase of our accrual for severance pay that would be payable to Mr. Shen if we were to terminate his employment; \$(28,597) represents the decrease of the accrual for sick leave and vacation days redeemable by Mr. Shen; and \$(5,526) represents the decrease in our accrual for severance pay that would be payable to Mr. Shen under the laws of the State of Israel if we were to terminate his employment. Mr. Shen left our employ effective March 31, 2006, and these amounts were accordingly paid to him.
- ⁽¹⁸⁾ Of this amount, \$35,131 represents payment to Mr. Shen for redemption of accrued but unused vacation days.
- ⁽¹⁹⁾ Of this amount, \$21,568 represents the increase in our accrual for vacation days redeemable by Mr. Shen; and \$13,404 represents the increase of our accrual for severance pay that would be payable to Mr. Shen under the laws of the State of Israel if we were to terminate his employment.
- ⁽²⁰⁾ Of this amount, \$8,369 represents the increase of the accrual for vacation days redeemable by Mr. Shen; and \$(1,628) represents the decrease of our accrual for severance pay that would be payable to Mr. Shen under the laws of the State of Israel if we were to terminate his employment.

Executive Loans

In 1999, 2000 and 2002, we extended certain loans to our Named Executive Officers. These loans are summarized in the following table, and are further described under "Certain Relationships and Related Transactions - Officer Loans," below.

<u>Name of Borrower</u>	<u>Date of Loan</u>	<u>Original Principal Amount of Loan</u>	<u>Amount Outstanding as of 12/31/05</u>	<u>Terms of Loan</u>
Robert S. Ehrlich	12/28/99	\$ 167,975	\$ 201,570	Ten-year non-recourse loan to purchase our stock, secured by the shares of stock purchased. Twenty-five-year non-recourse loan to purchase our

Robert S. Ehrlich	02/09/00	\$	789,991	\$	692,102	stock, secured by the shares of stock purchased.
Robert S. Ehrlich	06/10/02	\$	36,500	\$	40,343	Twenty-five-year non-recourse loan to purchase our stock, secured by the shares of stock purchased.

Stock Options

The table below sets forth information with respect to stock options granted to the Named Executive Officers for the fiscal year 2005.

Option Grants in Last Fiscal Year

Name	Individual Grants		Exercise or Base Price (\$/Sh)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term⁽¹⁾	
	Number of Securities Underlying Options Granted	% of Total Options granted to Employees in Fiscal Year			5% (\$)	10% (\$)
Steven Esses	8,204	6.8%	\$ 5.46	12/29/10	\$ 12,376	\$ 27,348

⁽¹⁾ The potential realizable value illustrates the value that might be realized upon exercise of the options immediately prior to the expiration of their terms, assuming the specified compounded rates of appreciation of the market price per share from the date of grant to the end of the option term. Actual gains, if any, on stock option exercise are dependent upon a number of factors, including the future performance of the common stock and the timing of option exercises, as well as the executive officer's continued employment through the vesting period. The gains shown are net of the option exercise price, but do not include deductions for taxes and other expenses payable upon the exercise of the option or for sale of the underlying shares of common stock. The 5% and 10% rates of appreciation are mandated by the rules of the Securities and Exchange Commission and do not represent our estimate or projection of future increases in the price of our stock. There can be no assurance that the amounts reflected in this table will be achieved, and unless the market price of our common stock appreciates over the option term, no value will be realized from the option grants made to the executive officers.

The table below sets forth information for the Named Executive Officers with respect to aggregated option exercises during fiscal 2005 and fiscal 2005 year-end option values.

Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values

Name	Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Un-exercised Options at Fiscal Year End		Value of Unexercised In-the-Money Options at Fiscal Year-End⁽¹⁾	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Robert S. Ehrlich	- \$	-	150,000	0 \$	0 \$	0
Steven Esses	- \$	-	73,929	0 \$	0 \$	0
Avihai Shen	- \$	-	44,261	0 \$	0 \$	0

⁽¹⁾ Options that are "in-the-money" are options for which the fair market value of the underlying securities on December 31, 2005 (\$5.18) exceeds the exercise or base price of the option.

Employment Contracts***Robert S. Ehrlich***

Mr. Ehrlich is party to an employment agreement with us executed in May 2005, effective as of January 1, 2005. The term of this employment agreement expires on December 31, 2007, and is extended automatically for additional terms of one year each unless either Mr. Ehrlich or we terminate the agreement sooner.

The employment agreement provides for a base salary of \$23,750 per month in 2005, \$25,000 per month in 2006, and \$26,500 per month in 2007, as adjusted annually for Israeli inflation and devaluation of the Israeli shekel against the U.S. dollar, if any. Additionally, the board may at its discretion raise Mr. Ehrlich's base salary. Mr. Ehrlich is currently receiving, with his consent, a reduced salary in an effort on our part to cut costs.

The employment agreement provides that we will pay a bonus, on a sliding scale, in an amount equal to a minimum of 35% of Mr. Ehrlich's annual base salary then in effect, up to a maximum of 90% 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.

The employment agreement also contains various benefits customary in Israel for senior executives (please see "Business - Employees," above), tax and financial planning expenses and an automobile, and contains confidentiality and non-competition covenants. Pursuant to the employment agreement, 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 (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 due for the year in which employment is terminated (in an amount of not less than 35% of base salary) and severance pay in the amount of \$1,625,400 and bonus at the minimum rate, except that in the event of termination of the agreement following a change of control, the amount payable is doubled. Furthermore, certain benefits will continue and all outstanding options will be fully vested.

Pursuant to the terms of our employment agreement Mr. Ehrlich, funds to secure payment of Mr. Ehrlich's contractual severance are to be deposited in a Rabbi Trust for his benefit, with payments to the Rabbi Trust to be made pursuant to an agreed-upon schedule. As of December 31, 2005, a total of \$454,859 had been deposited in this Rabbi Trust. Pursuant to the terms of the Rabbi Trust, funds in the Rabbi Trust continue to be owned by us, and benefit from all gains and bear the risk of all losses resulting from investments of Rabbi Trust funds.

Steven Esses

Mr. Esses is party to an employment agreement with us executed in May 2005, effective as of January 1, 2005. The term of this employment agreement expires on December 31, 2006, and is extended automatically for additional terms of two years each unless either Mr. Esses or we terminate the agreement sooner.

The employment agreement provides for a base salary of \$5,000 per month, as adjusted annually for Israeli inflation and devaluation of the Israeli shekel against the U.S. dollar, if any. Additionally, the board may at its discretion raise Mr. Esses's base salary.

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 25% 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.

The employment agreement also contains various benefits customary in Israel for senior executives (please see "Business - Employees," above), 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, 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 due for the year in which employment is terminated (in an amount of not less than 20% of base salary) and severance pay in the amount of \$330,000, except that in the event of termination of the agreement following a change of control, the amount payable is doubled. Furthermore, certain benefits will continue (for a shorter period, in the event of early retirement) and all outstanding options will be fully vested.

Pursuant to the terms of our employment agreement Mr. Esses, funds to secure payment of Mr. Esses's contractual severance are to be deposited in a Rabbi Trust for his benefit, with payments to the Rabbi Trust to be made pursuant to an agreed-upon schedule. As of December 31, 2005, no funds had been deposited in this Rabbi Trust. Pursuant to the terms of the Rabbi Trust, funds in the Rabbi Trust continue to be owned by us, and benefit from all gains and bear the risk of all losses resulting from investments of Rabbi Trust funds.

See also "Certain Relationships and Related Transactions - Consulting Agreement with Sampen Corporation," below.

Thomas J. Paup

Mr. Paup is party to an employment agreement with us dated December 30, 2005. Under the terms of his employment agreement, Mr. Paup is entitled to receive a base salary of \$135,000 per annum, and will be eligible for a bonus with a target equal to between 20% and 50% of the base salary. The actual bonus payout shall be determined based upon the Company's achievement level against financial and performance objectives determined by the Compensation Committee of our Board of Directors.

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.

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 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.s. of the Notes to the Consolidated Financial Statements.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee of our board of directors for the 2005 fiscal year consisted of Dr. Jay M. Eastman, Jack E. Rosenfeld and Edward J. Borey. None of the members has served as our officers or employees.

**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 June 30, 2006, 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 Beneficially Owned⁽²⁾⁽³⁾	Percentage of Total Shares Outstanding⁽³⁾
Robert S. Ehrlich	209,466 ⁽⁴⁾	3.0%
Steven Esses	85,714 ⁽⁵⁾	1.2%
Avihai Shen**	47,153 ⁽⁶⁾	*
Thomas J. Paup	3,571 ⁽⁷⁾	*
Dr. Jay M. Eastman	7,024 ⁽⁸⁾	*
Jack E. Rosenfeld	7,166 ⁽⁹⁾	*
Lawrence M. Miller	35,486 ⁽¹⁰⁾	*
Edward J. Borey	4,237 ⁽¹¹⁾	*
Prof. Seymour Jones	0	*
All of our directors and executive officers as a group (9 persons)	399,817 ⁽¹²⁾	5.6%

* Less than one percent.

** Mr. Shen ceased to act as our Chief Financial Officer in February 2006, and his employment with us terminated on March 31, 2006.

⁽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 8,468,957 shares of common stock outstanding as of June 30, 2006. 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 44,154 shares held directly by Mr. Ehrlich, 3,571 shares held by Mr. Ehrlich's wife (in which shares Mr. Ehrlich disclaims beneficial ownership), 11,527 shares held in Mr. Ehrlich's pension plan, 214 shares held by children sharing the same household (in which shares Mr. Ehrlich disclaims beneficial ownership), and 150,000 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽⁵⁾ Consists of 11,785 shares held directly by Mr. Esses and 73,929 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽⁶⁾ Consists of 2,892 shares owned directly by Mr. Shen and 44,261 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽⁷⁾ Consists of 3,571 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽⁸⁾ Consists of 7,024 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽⁹⁾ Consists of 142 shares owned directly by Mr. Rosenfeld and 7,024 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽¹⁰⁾ Consists of 851 shares held directly by Mr. Miller, 26,897 shares held by Leon S. Gross and Lawrence M. Miller as co-trustees of the Rose Gross Charitable Foundation, and 7,738 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽¹¹⁾ Consists of 1,142 shares owned directly by Mr. Borey and 3,095 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

⁽¹²⁾ Includes 296,642 shares issuable upon exercise of options exercisable within 60 days of June 30, 2006.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Officer Loans

On December 3, 1999, Robert S. Ehrlich purchased 8,928 shares of our common stock out of our treasury at the closing price of the common stock on December 2, 1999. Payment was rendered by Mr. Ehrlich in the form of non-recourse promissory notes due in 2009 in the amount of \$167,975, bearing simple annual interest at a rate of 2%, secured by the shares of common stock purchased and other shares of common stock previously held by him. As of December 31, 2005, the aggregate amount outstanding pursuant to this promissory note was \$201,570.

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 \$789,991, bearing annual interest (i) as to \$329,163, at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, and (ii) as to \$460,828, at 4% over the then-current percentage increase in the Israeli consumer price index between the date of the loan and the date of the annual interest calculation, 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, 2005, the aggregate amount outstanding pursuant to this promissory note was \$692,102.

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, 2005, the aggregate amount outstanding pursuant to this promissory note was \$40,343.

Director Consulting Agreements

In January 2004, Mr. Edward J. Borey, who became one of our directors in December 2003, entered into a consulting agreement with us pursuant to which he agreed to aid us in identifying potential acquisition candidates in exchange for transaction fees in respect of acquisitions in which he plays a “critical role” (as determined by us in our sole and absolute discretion) in identifying and/or initiating and/or negotiating the transaction in the amount of (i) 1.5% of the value of the transaction up to \$10,000,000, plus (ii) 1.0% of the value of the transaction in excess of \$10,000,000 and up to \$50,000,000, plus (iii) 0.5% of the value of the transaction in excess of \$50,000,000. We also agreed to issue to Mr. Borey, at par value, a total of 2,284 shares of our common stock, the value of which is to be deducted from any transaction fees paid. 1,142 of these shares were earned and issued prior to termination of this agreement in August 2004.

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 Sampen. The term of this consulting agreement expires on December 31, 2006, and is extended automatically for additional terms of two years each unless either Sampen or we terminate the agreement sooner.

Pursuant to the terms of our agreement with Sampen, Sampen provides one of its employees to us for such employee to serve as our Executive Vice President and Chief Operating Officer. 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.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

This prospectus is part of a Form S-1 registration statement that we have filed with the Securities and Exchange Commission relating to the shares of our common stock being offered hereby. This prospectus does not contain all of the information in the Registration Statement and its exhibits. The Registration Statement, its exhibits and the documents incorporated by reference in this prospectus and their exhibits, all contain information that is material to the offering of the common stock. Whenever a reference is made in this prospectus to any of our contracts or other documents, the reference may not be complete. You should refer to the exhibits that are a part of the Registration Statement in order to review a copy of the contract or documents. The registration statement and the exhibits are available at the Securities and Exchange Commission's Public Reference Room or through its Website.

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. You can read and copy any materials we file with the Securities and Exchange Commission at its Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 and at its regional offices, a list of which is available on the Internet at <http://www.sec.gov/contact/addresses.htm>. You may obtain information on the operation of the Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission maintains an Internet site at <http://www.sec.gov> that contains reports, proxy and information statements, and other information regarding issuers, such as us, that file electronically with the Securities and Exchange Commission. Additionally, you may access our filings with the Securities and Exchange Commission through our website at <http://www.arotech.com/compro/index.html>. The information on our website is not part of this prospectus.

We will provide you without charge, upon your oral or written request, with a copy of any or all reports, proxy statements and other documents we file with the Securities and Exchange Commission, as well as any or all of the documents incorporated by reference in this prospectus or the registration statement (other than exhibits to such documents unless such exhibits are specifically incorporated by reference into such documents). Requests for such copies should be directed to:

Investor Relations Department
Arotech Corporation
c/o Victor Allgeier
TTC Group
100 Maiden Lane, Suite 921
New York, New York 10038
Telephone number: (646) 290-6400

INFORMATION INCORPORATED BY REFERENCE

The Securities and Exchange Commission allows us to "incorporate by reference" in this prospectus certain of the information we have filed with them, which means that:

- incorporated documents are considered part of this prospectus; and
- we can disclose important information to you by referring you to those documents.

We incorporate by reference the documents listed below:

- the description of our common stock contained in the Registration Statement on Form 8-A, Commission File No. 0-23336, as filed with the Securities and Exchange Commission on February 2, 1994;
- our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission on March 31, 2006, as amended by our Form 10-K/A filed with the Securities and Exchange Commission on June 16, 2006 and our Form 10-K/A filed with the Securities and Exchange Commission on July 24, 2006;

- our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2006, filed with the Securities and Exchange Commission on May 15, 2006, as amended by our Form

10-Q/A filed with the Securities and Exchange Commission on July 24, 2006;

- our Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2006, filed with the Securities and Exchange Commission on August 14, 2006;
- our Current Reports on Form 8-K filed with the Securities and Exchange Commission on April 7, 2006, April 12, 2006, May 18, 2006, June 19, 2006, June 26, 2006 and July 10, 2006; and
- our definitive proxy statement on Schedule 14A filed with the Securities and Exchange Commission on May 10, 2006.

**4,360,721 Shares
Common Stock**



PROSPECTUS

August 25, 2006

OMB APPROVAL

OMB Number:	3235-0063
Expires:	April 30, 2009
Estimated average burden hours per response	2,196.00

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

FORM 10-K

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006 .**

☐ **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
Common Stock, \$0.01 par value

Name of each exchange on which registered
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 ☒ No ☐**

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 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, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer: ☐ Accelerated filer: ☐ Non-accelerated filer: ☒

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 30, 2006 was approximately \$19,309,813 (based on the last sale price of such stock on such date as reported by The Nasdaq National 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: **11,983,576 as of 3/31/07**

Documents incorporated by reference:

None

**Potential persons who are to respond to the collection of
information contained in this form are not required to respond
unless the form displays a currently valid OMB control number.**

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.

PART I

ITEM 1. BUSINESS

General

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

- We develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force training and driving training of military, law enforcement, security and other personnel through our ***Simulation and Training Division***:
 - We provide simulators, systems engineering and software products to the United States military, government and private industry through our subsidiary FAAC Incorporated, located in Ann Arbor, Michigan (“FAAC”); and
 - We provide specialized “use of force” training for police, security personnel and the military through our subsidiary IES Interactive Training, Inc., located in Ann Arbor, Michigan (“IES”).
- We utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles and to manufacture aviation armor through our ***Armor Division***:
 - We use state-of-the-art lightweight armoring materials, special ballistic glass and advanced engineering processes to fully armor military and civilian SUV’s, buses and vans, through our subsidiaries MDT Protective Industries, Ltd., located in Lod, Israel (“MDT”), of which we own 75.5%, and MDT Armor Corporation, located in Auburn, Alabama (“MDT Armor”), of which we own 88%; and
 - We provide ballistic armor kits for rotary and fixed wing aircraft and marine armor through our subsidiary Armour of America, located in Auburn, Alabama (“AoA”).
- We manufacture and sell lithium and Zinc-Air batteries for defense and security products and other military applications through our ***Battery and Power Systems Division***:
 - We develop and sell rechargeable and primary lithium batteries and smart chargers to the military and to private defense industry in the Middle East, Europe and Asia through our subsidiary Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel’s Negev desert area) (“Epsilor”);

- We develop, manufacture and market primary Zinc-Air batteries, rechargeable batteries and battery chargers for the military, focusing on applications that demand high energy and light weight, through our subsidiary Electric Fuel Battery Corporation, located in Auburn, Alabama (“EFB”); and
- We produce water-activated lifejacket lights for commercial aviation and marine applications through our subsidiary Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel (“EFL”).

Background

We were incorporated in Delaware in 1990 under the name “Electric Fuel Corporation,” and we changed our name to “Arotech Corporation” on September 17, 2003. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and Arotech’s wholly-owned Israeli subsidiaries, EFL and Epsilon; Arotech’s majority-owned subsidiaries, MDT (in Israel) and MDT Armor (in the U.S.); and Arotech’s wholly-owned United States subsidiaries, EFB, IES, FAAC and AoA.

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

Facilities

Our principal executive offices are located at 1229 Oak Valley Drive, Ann Arbor, Michigan 48108, and our toll-free telephone number at our executive offices is (800) 281-0356. Our corporate website is www.arotech.com. Our periodic reports, as well as recent filings relating to transactions in our securities by our executive officers and directors, that have been filed with the Securities and Exchange Commission in EDGAR format are made available through hyperlinks located on the investor relations page of our website, at <http://www.arotech.com/compro/investor.html>, as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Reference to our websites does not constitute incorporation of any of the information thereon or linked thereto into this annual report.

The offices and facilities of three of our principal subsidiaries, EFL, MDT and Epsilon, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel’s pre-1967 borders). Most of the members of our senior management work extensively out of EFL’s facilities; our financial operations are conducted primarily from our principal executive offices in Ann Arbor. IES’s and FAAC’s home offices and facilities are located in Ann Arbor, Michigan, and the offices and facilities of EFB, MDT Armor and AoA are located in Auburn, Alabama.

Simulation and Training 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 Simulation and Training Division, the largest of our three divisions. During 2006, 2005 and 2004 revenues from our Simulation and Training Division were approximately \$22.0 million, \$26.8 million and \$21.5 million, respectively.

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

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

Vehicle Simulation

We provide simulators, systems engineering and software products focused on training vehicle operators for cars and trucks. We provide these products to the United States military, government 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 conscientious equipment operation. Our simulators have successfully trained hundreds of thousands of drivers. Our customer base includes all branches of the U.S. Department of Defense, state and local governments, and municipal entities.

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, buses, fire trucks, police cars, ambulances, airport ground vehicles, and military vehicles - for municipal, governmental and foreign customers. In 2006, our Vehicle Simulations group accounted for approximately 57% of our Simulation and Training Division's revenues.

Simulators are cost-effective solutions, enabling users to reduce overall aircraft and ground vehicle usage, vehicle maintenance costs, fuel costs, repairs, and spares expenditures. For example, our Medium Tactical Vehicle Replacement (MTVR) simulators have reduced total driver training time by up to 35%. Many customers have reduced actual "behind-the-wheel" time by up to 50% while still maintaining or improving safety. Additionally, for customers with multiple simulators, the corresponding increase in the student to instructor ratio has reduced instructor cost per student.

The implementation of our vehicle driving simulators has led to measurable benefits. North American Van Lines, one of our earliest vehicle simulator customers, has shown a 22% reduction in preventable accidents since it began using our simulators. The German Army, one of our earliest Military Vehicle customers, showed better driver testing scores in 14 of 18 driver skills compared to classroom and live driver training results. Additionally, the New York City Transit Authority documented a 43% reduction in preventable accidents over its first six months of use and has reduced its driver hiring and training "washout" by 50%.

Simulators can produce more drastic situations than can traditional training, which inherently produces drivers that are more skilled in diverse driving conditions. For example, while many first-time drivers will learn to drive during the summer months, they are not trained to drive in wintry conditions. Simulators can produce these and other situations, such as a tire blowout or having to react to a driver cutting off the trainee, effectively preparing the driver for adverse conditions.

We believe that we have held near a 100% 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.

PRODUCT LINES

Below is a description of our Vehicle Simulation group's products and product lines.

Military Vehicle Simulators

Military Vehicles comprise the majority of our vehicle simulation business. Military vehicle simulators are highly realistic vehicle simulators that include variable reactive traffic and road conditions, the capacity to customize driving conditions to be geography-specific, and training in hazardous and emergency conditions. We have several large contracts and task orders in the Military Vehicles business, including (i) a multi-year IDIQ task-order contract for the development of vehicle simulators and related training services for the U.S. armed services; (ii) a series of scheduled General Services Administration purchases of simulators; (iii) continuing Congressional plus-up funding for simulators to the Army National Guard; and (iv) a contract to develop a series of Common Driver Trainers for the U.S. Army.

Our military vehicle simulators provide complete training capabilities, based on integrated, effective simulation solutions, to military vehicle operators in the U.S. Armed Forces. Our flagship military vehicle simulation product is our Military Operator Driver Simulator, initially developed for the USMC and subsequently reconfigured and delivered to support the U.S. Army and U.S. Naval Construction Battalion. The MIL ODS concept is centered on a pod of up to six Student Training Stations (STS) and a single controlling Instructor Operator Station (IOS). The STS realistically simulates the form, fit, and feel of the vehicle being modeled. The high-fidelity version of the STS consists of a modified production cab unit mounted on a full six-degree-of-freedom motion platform. Other versions with industry exclusive seat-motion and generic reconfigurable cabs are available. The STS provides a field of view of over 180-degrees into a realistically depicted virtual world, simulating a variety of on-road and off-road conditions. The IOS is the main simulation control point supporting the instructor's role in simulator training. The IOS initializes and configures the attached STS, conducts training scenarios, assesses student performance, and maintains scenarios and approved curriculum. In 2006, the U.S. Air Force joined the Marines, Army and Navy as customers of our military vehicle simulators.

Our software solution provides a complete operator training curriculum based upon integrated simulation training. Military vehicle simulators enable students to learn proper operational techniques under all terrain, weather, road, and traffic conditions. Instructors can use simulators as the primary instructional device, quantitatively evaluating student performance under controlled, repeatable scenarios. This monitoring, combined with the ability to create hazardous and potentially dangerous situations without risk to man or material, results in well-trained students at significantly less cost than through the use of traditional training techniques. In addition to standard on-road driver training, our military vehicle simulators can provide training in such tasks as:

- Off-road driving on severe slopes, including muddy or swampy terrain;
- Driving in night vision goggle and blackout conditions;
- Convoy training; and
- The use of the Central Tire Inflation System in response to changing terrain.

In addition to simulation systems, we offer on-site operator and maintenance staff, train-the-trainer courses, curriculum development, scenario development, system maintenance, software upgrades, and warranty packages to our U.S. Armed Forces customers.

Municipal Vehicles

The Municipal Vehicles business is comprised of technology similar to that of the Military Vehicles product line and also is customized to reflect the specific vehicle being simulated. We serve three primary customer bases in the Municipal Vehicles business: transit, public safety, and corporate.

Transit

Transit customers represent an attractive customer base as they generally have access to their own funds, which often exempts them from the lengthy and complex process of requesting funds from a governing body. We have provided bus simulators to many of the leading U.S. transit authorities, including the New York City Transit Authority, Washington, D.C. Metro, Los Angeles MTA, Dallas Area Rapid Transit, and the Chicago Transit Authority. Our first European bus simulator was installed in London in 2005, and we were competitively awarded a major rail simulator program with New York City Transit that we anticipate completing early in 2007.

Public Safety

We target municipal customers in police departments, hospitals, fire departments, and departments of transportation for sales of our municipal product. Our customers include the Mexico Department of Education, California Department of Transportation, and the Fire Departments of New York and Washington, D.C. We are developing an industry advisory group focusing on the municipal market to identify and address customer needs. Additionally, we have developed a simulator module to extend the simulation once police, fire, or emergency medical service personnel reach the incident location. We believe that this represents another of our bases of differentiation over our competition.

One of our more recent products is our Incident Command Training (ICT) system. Our custom ICT system includes a comprehensive suite of simulation tools to promote both strategic and tactical training for firefighters facing incidents that require a well defined command and control structure. The ICT system, the first of which has been installed at the new Los Angeles Fire Fighter Training Academy, includes a broad range of incidents typically faced by firefighters as well as incidents involving weapons of mass destruction (WMD) and other acts of terrorism. The ICT system will provide immersive training for single agency incidents involving the fire service alone, as well as interagency incidents requiring a unified command structure including fire, police, emergency medical services, utilities, and other emergency response agencies.

Corporate

We target corporate fleets and “for-hire” haulers as customers of the corporate simulator product. These customers use simulators to train personnel effectively as well as to avoid the brand damage that could be associated with poor driver performance. To date, we have provided simulators to customers such as Challenger Transportation, Schlumberger Oil Services, Kramer Entertainment, and North American Van Lines.

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 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 ranges (such as Top Gun) to full task training devices such as the F-18 Weapon Tactics Trainer. In 2006, our Military Operations group accounted for 17% of our Simulation and Training Division’s revenues.

We supply on-board software to support weapon launch decisions for the F-15, F-16, F-18, and Joint Strike Fighter (JSF) fighter aircraft. Pilots benefit by having highly accurate presentations of their weapon’s capabilities, including susceptibility to target defensive reactions. We designed and developed an instructor operator station, mission operator station and real-time, database driven electronic combat environment for the special operational forces aircrew training system. The special operational forces aircrew training system provides a full range of aircrew training, including initial qualification, mission qualification, continuation, and upgrade training, as well as combat mission rehearsal.

PRODUCT LINES

We provide air combat range software, missile launch envelope decision support software, the SimBuilder™ simulation software product, and Weapon System Trainer software through the Military Operations business line.

Below is a description of our Military Operations group’s products and product lines.

Air Combat Range Software

We serve the U.S. Air Force Air Combat Training System and U.S. Navy Tactical Aircrew Training System with our air combat training range software. Air combat training ranges allow pilots to train and evaluate new tactics in a controlled airborne environment. Air “battles” are extremely realistic, with our software determining the outcome of weapon engagements based on launch conditions and the target aircraft defensive reactions.

Missile Launch Envelope Software

Onboard weapon decision-making software enables pilots to assimilate the complex information presented to them. In 2005, we added the F-16 to the F-15, F-18 and Joint Strike Fighter (JSF) to strengthen the list of aircraft fielding FAAC MLE software. We provide our missile launch envelope software to the U.S. Navy and Air Force through our subcontracting relationships with Boeing and Raytheon.

SimBuilder™

The SimBuilder™ simulation software product is designed to provide weapons simulation models for use in training environments for launched weapons. This software enables foreign end-users to use weapons simulation models similar to the U.S. military without classified U.S. weapons data. Militaries of Australia, the United Arab Emirates, Canada, Taiwan, and Singapore currently use SimBuilders™.

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 military, law enforcement and corporate client communities. We believe, based on our general knowledge of the size of the interactive use-of-force market, our specific knowledge of the extent of our sales, and discussions we have held with customers at trade shows, etc., that we provide more than 25% of the worldwide market for government and military judgment training simulators. We conduct our interactive training activities using our IES Interactive Training nameplate. In 2006, our Use of Force group accounted for 26% of our Simulation and Training Division's revenues.

PRODUCT LINES

We offer consumers the following interactive training products and services:

- *MILO (Multiple Interactive Learning/training Objectives)* - provides use-of-force simulation for military and law enforcement. This simulator designed with "plug in" modules to customize the training system to meet end user needs. We believe that the MILO is the most technologically advanced judgment-training simulator in the world.
- *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.
- *Range FDU (Firearms Diagnostic Unit)* - a unique combination of training and interactive technologies that give instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.
- *IES Studio Productions* - providing cutting edge multimedia video services for law enforcement, military and security agencies, utilizing the newest equipment to create the training services required by the most demanding authorities.

Our products feature state of the art, high-definition, all-digital video formats, ultra-advanced laser-based lane detection for optimal accuracy and performance, customer-based authoring of training scenarios, and are 95% COTS (commercial off-the-shelf)-based system.

PRODUCTS

Below is a description of each of the core products and services in the IES line.

MILO

MILO (Multiple Interactive Learning/training Objectives) is a simulator designed with “plug in” modules to customize the training system to meet end user needs, and is designed to expand the market for sales of our IES products to include organizations involved in all aspects of public safety.

The MILO System allows training with respect to the full “Use of Force” continuum. Training can be done on an individual basis, or as many as four members of a team can participate simultaneously and be scored and recorded individually. Topics of training include (but are not limited to):

- *Officer’s Presence and Demeanor* - Picture-on-picture digital recordings of the trainee’s actions allow visual review of the trainee’s reaction, body language and weapons handling during the course of the scenario, which then can be played back for debriefing of the trainee’s actions.
- *Verbalization* - Correct phrases, timing, manner and sequence of an officer’s dialogue are integrated within the platform of the system, allowing the situation to escalate or de-escalate through the officer’s own words in the context of the scenario and in conjunction with the trainer.
- *Less-Than-Lethal Training* - Training in the use of non-lethal devices such as TASER, OC (pepper spray), batons and other devices can be used with the video training scenarios with appropriate reactions to each. We produce an interactive system especially for TASER products called the TASER™ Judgmental Trainer, which delivers advance simulated training for law enforcement and government agencies deploying TASER non-lethal devices.
- *Soft Hand Tactics* - Low level physical control tactics with the use of additional equipment such as take-down dummies.
- *Firearms Training and Basic Marksmanship* - Either utilizing laser based training weapons or in conjunction with a live-fire screen, the use of “Live Ammunition” training can be employed on the system.

The interactive training scenarios are projected either through single or multiple screens and projectors, allowing us to immerse a trainee in true-to-life training scenarios and incorporating one or all the above training issues in the “Use of Force” continuum.

A2Z Classroom Trainer

The A2Z is 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.

Using individual hand-held keypads, the students can answer true/false or multiple choice questions. Based on the student's performance, the scenario will branch and unfold to a virtually unlimited variety of different possible outcomes of the student's actions. The system logs and automatically scores each and every trainee's response and answer. At the end of the scenario, the system displays a session results summary from which the trainer can debrief the class.

The advanced A2Z Courseware Authoring Tools allow the trainer easily to create complete customized interactive courses and scenarios.

The Authoring Tools harness advances in digital video and multimedia, allowing the trainer to capture video and graphics from any source. The A2Z allows the trainer to combine his or her insight, experience and skills to recreate a realistic learning environment. The A2Z Training System is based on the well-known PC-Pentium® technology and Windows XP® operated. The menu and mouse operation make the A2Z user-friendly.

The individual keypads are connected "wirelessly." The system is completely portable and may be setup within a matter of minutes.

Key advantages:

- Provides repeatable training to a standard based on established policy
- Quick dissemination and reinforcement of correct behavior and policies
- Helps reduce liability
- More efficient than "traditional and redundant" role-playing methods
- Realistic scenarios instead of outdated "play-acting"
- Interactive training of up to 250 students simultaneously with wireless keypads
- Easy Self-Authoring of interactive training content
- PC platform facilitates low cost of ownership
- Easy to use Windows XP-based software
- Easy to deploy in any classroom

Range FDU

The Range FDU (firearm diagnostics unit) is a unique combination of training and interactive technologies that gives instructors a first-person perspective of what trainees are seeing and doing when firing a weapon.

With the Range FDU, firearms instructors can see the trainees' actual sight alignment to the target as well as measure trigger pressure against proper trigger pressure graphs, making corrective instruction simple and effective. In addition, the Range FDU records a trainee's recoil control, grip and stance - allowing the instructor to play back the information in slow motion or real time to better analyze the trainee's actions and more accurately diagnose any deficiencies.

The Range FDU also has the ability to record the firearm instruction session to either DVD or VHS, allowing both the trainee and the instructor to review it at a later time. Trainees now have a diagnostic tool that they can learn from, even after their training has been completed. In addition, instructors can build a library for each trainee to record progress.

The Range FDU provides the following benefits:

- Fall of shot feedback
- Trigger pressure analysis
- Recoil control, grip and stance assessment
- Sight alignment
- Sight picture analysis and target reacquisition

IES Studio Productions

We develop professional courseware for use exclusively with IES's interactive systems. Courses are designed to address specific department issues, and can be customized to fit each agency's needs. These courses are available in boxed sets that provide the customer with a turn-key training session. The A2Z Classroom Trainer and the MILO System are used to deliver the curriculum and create a virtual world that the trainees respond and react to. Strategic relationships with high profile companies such as H&K Firearms, and TASER International, provide customers with training that deals with cutting edge issues facing law enforcement today. The incorporation of our courseware library along with simulation systems allows training to remain consistent and effective, giving customers more value for their training dollar.

Marketing and Customers

We market our Simulation Division products to all branches of the U.S. military and we continue to expand our global footprint. 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.

VEHICLE SIMULATION AND MILITARY OPERATIONS

Marketing

Our sales and marketing effort focuses on developing new business opportunities as well as generating follow-on sales of simulators and upgrades. We currently employ four dedicated sales representatives who focus on Vehicle Simulation and Military Operations opportunities. Furthermore, two additional employees spend a significant portion of their time in sales. Various members of FAAC's senior management serve as effective sales representatives in the generation of municipal, military, and corporate business. We also retain the services of several independent consultants who act as marketing agents on our behalf. These representatives are largely commission-based agents who focus on particular products and/or regions (such as airport customers, Texas, California, and Eglin Air Force Base). Finally, we have four customers that have agreements wherein the companies support our marketing efforts and market our products themselves in exchange for commissions and/or free upgrade services.

Our sales representatives are salaried employees with minimal commission-based revenue. Independent consultants generally do not receive a base salary and receive 5% to 10% commissions on the amount of business that they generate each year. The majority of our sales representatives have engineering backgrounds that they leverage to anticipate the technical needs of our customer base and targeted markets. Additionally, the program manager and service department assist us in gaining repeat business.

Our military operations group operates primarily by developing a pipeline of follow-on work through strong program performance. We have a long history of repeat and follow-on work with programs such as F-15, F-16, F-18 and JSF ZAP (over 25 contracts with Boeing and Raytheon). Additionally, we have had weapon simulation support contracts with the U.S. Navy and US Air Force going back over 25 years.

Customers

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, 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.

USE OF FORCE

Marketing

Municipalities throughout the U.S. are using our use-of-force products and our penetration in Asia, Europe and the Americas continues through the use of commissioned sales agents.

We market our use-of-force products and services to domestic and international law enforcement, military and other federal agencies and to various companies that serve them, through attendance and presentations at conferences, exhibits at trade shows, and web pages and paid placements on the Internet. Over half of our business is generated from returning customers and enduring customer relationships.

We have nine full-time sales and business development professionals and are actively seeking additional qualified candidates to augment this team. We use commissioned representatives to prosecute most OCONUS opportunities.

We typically participate in over twenty industry conferences annually, held throughout the United States and in other countries, that are attended by our potential customers and their respective purchasing and budgeting decision makers. A significant percentage of our sales of IES products are sold through leads developed at these shows. We also advertise in selected publications of interest to potential customers.

Customers

Purchasers of our IES products have included the FBI, the Secret Service, the Bureau of Alcohol, Tobacco and Firearms, the Customs Service, the Federal Protective Service, the Border Patrol, the Coast Guard, the Federal Law Enforcement Training Centers, the Department of Health and Human Services, the California Department of Corrections, NASA, and police departments throughout the U.S. as well as international users such as the Israeli Defense Forces, the German National Police, the Royal Thai Army, the Hong Kong Police, the Russian Security Police, users in Mexico and the United Kingdom, and many others.

The mix of customers has historically been approximately 40% city and state agencies, 30% federal agencies, and 30% international.

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.

We differentiate ourselves from our competition on several bases:

- Leading Technology – We believe that we offer better-developed, more dynamic software than our competitors. Additionally, we incorporate leading graphics and motion-cueing technologies in our systems to provide customers with the most realistic simulation experience on the market.
- Long History in the Simulation Software Business – As a market leader in the simulation software business for more than thirty years, FAAC's professionals understand customer requirements and operating environments. Thus, we build our software to meet and exceed demanding customers' expectations.
- Service Reputation – We are known for providing strong customer service, a characteristic that drives new business within our chosen markets.
- Standardized Development Processes – We generally deliver our products to market quickly and at high quality due to our standardized development processes.

Military Vehicles

FAAC has been the sole provider of wheeled vehicle simulation solutions to the U.S. military since 1999. Our devotion to developing realistic, comprehensive products for a wide range of vehicle types positions us as a preferred simulation provider within this market niche. Our strategy of identifying a training need, isolating government funds, and then developing a customized training solution has led to considerable successes. This approach, which differs from the “build first and market later” strategy employed by a number of our competitors, effectively identifies market opportunities and provides a better product to the military customer. Diversified defense companies and municipal simulation providers have attempted to enter the military wheeled vehicle market but have been unsuccessful thus far. Although we believe that market penetration by these companies is ultimately inevitable, the established FAAC brand, understanding of customer requirements, and engineering expertise provide us with a competitive advantage in this market segment. Our primary competitors for military vehicle simulation solutions include Lockheed Martin Corporation’s Information & Technology Services Group, L-3 Communications Holdings, Raydon Corporation, and the Cubic Defense Applications division of Cubic Corporation.

Municipal Vehicles

A handful of simulation product and service companies currently compete with our targeted municipal driving simulator markets. However, our marketing and development of selected municipal market segments has positioned us as a leading provider of municipal simulation solutions. Competition within each market segment varies, but the following companies generally participate in selected driving simulator market opportunities: L-3 Communications Holdings, Doron Precision Systems, Lockheed-Martin Corporation’s LMIS Division, Global SIM, and USADriveSafe, Inc.

MILITARY OPERATIONS

Currently no significant competitors participate in the markets we serve around our weapon simulation niche. Our 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.

We believe the key factors in our competing successfully in this field continue to be our ability to develop simulation software and related products and services to effectively train law enforcement and military to today’s standards, our ability to develop and maintain proprietary technologically advanced hardware solutions, and our ability to develop and maintain relationships with departments and government agencies.

Armor Division

We armor vehicles and manufacture aviation and other armor through our Armor Division. During 2006, 2005 and 2004 revenues from our Armor Division were approximately \$12.6 million, \$12.3 million and \$18.0 million, respectively (on a pro forma basis, assuming we had owned all components of our Armor Division since January 1, 2004, revenues in 2006, 2005 and 2004 would have been approximately \$12.6 million, \$12.3 million and \$29.2 million, respectively).

Introduction

We specialize in armoring vehicles and manufacturing armor kits for aircraft and vessels by using state-of-the-art lightweight ballistic materials, special ballistic glass and advanced engineering processes. We fully armor vehicles, vans, SUVs and small buses and we provide ballistic armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, and armor for architectural applications.

We operate through three business units: MDT Protective Industries Ltd., located in Lod, Israel (in which we acquired a majority stake in 2002), MDT Armor Corporation, which we established in 2003 in Auburn, Alabama and Armour of America, which we acquired in 2004 and relocated in Auburn, Alabama.

We are a leading supplier to the Israeli military, Israeli Special Forces and special services. We provide products to the US Army, and to military and defense and paramilitary customers worldwide.

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

During 2006, we received over \$21.0 million in orders from the Israel Defense Forces for the David, a patrol, combat command and reconnaissance armored vehicle that is specifically designed as an urban combat vehicle.

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

Product Lines

We provide two main product lines - armored vehicles and armor kits.

ARMORED VEHICLES

Armoring a vehicle involves much more than just adding "armor plates." It includes professional and secure installation of a variety of armor components - inside doors, behind dashboards, and all other areas of passenger and engine compartments. We use overlapping sections to ensure protection from all angles, and install armored glass in the windshield and windows. We have developed certain unique features, such as new window operation mechanisms that can raise windows rapidly despite their increased weight, gun ports, run-flat tires, and more. We developed the majority of the materials that we use in-house or in conjunction with Israeli companies specializing in protective materials.

In order to armor a vehicle, we first disassemble the vehicle and remove the interior paneling, passenger seats, doors, windows, etc. We then fortify the entire body of the vehicle, including the walls, pillars, floors, roof and other critical components, and reinforce the door hinges. We achieve firewall protection from frontal assault with carefully designed overlapping armor. Options, such as air-conditioning, seating modifications and run-flat tires, are also available. We fix the armoring into the shell of the vehicle, ensuring that the installation and finishing is according to the standards set for that particular model. We then reassemble the vehicle as close to its original appearance as possible.

We armor a variety of vehicles for both commercial and military markets.

In the military market, we armor:

- The David, a combat patrol, command and reconnaissance armored vehicle that is specifically designed for urban combat;
- Command vehicles (such as the Land Rover Defender 110); and
- Pickup trucks, such as the Defender 130.

For the commercial market, we armor:

- Sports utility vehicles (such as the GM Suburban, the Toyota Land Cruiser and the Land Rover Defender);
- Pick-up trucks, such as the Ford F550;
- Passenger vans (such as the Chevrolet Express, the General Motors Savana and the Ford Econoline); and
- Small buses (based on vehicles in the Mercedes-Benz Vario and Sprinter lines).

Once we have ensured full vehicle protection, we place a premium on retaining the original vehicle's look and feel to the extent possible, including enabling full serviceability of the vehicle, thereby rendering the armoring process "invisible." We work with our customers to understand their requirements, and together with the customer develop an optimized armoring solution. A flexible design-to-cost process helps evaluate tradeoffs between heavy and light materials and various levels of protection.

By working within the vehicle manufacturer's specifications, we maintain stability, handling, center-of-gravity and overall integrity. Our methods minimize impact on payload, and do not obstruct the driver's or passengers' views. In many cases all the original warranties provided by the manufacturer are still in effect.

We offer a variety of armoring materials, optimized to the customer's requirements. We use ballistic steel, composite materials (including Kevlar®, Dyneema® and composite armor steel) as well as special ceramics, together with special armored glass. We use advanced engineering techniques and "light" composite materials, and avoid, to the extent possible, using traditional "heavy" materials such as armored steel because of the added weight, which impairs the driving performance and handling of the vehicle. We also sell certain kinds of vehicles pre-armored.

All materials that we use meet not only international ballistic standards, but also the far more stringent requirements set by the Israeli military, the Israeli Ministries of Defense and Transport, and the Israel Standards Institute.

ARMOR KITS

We provide two kinds of armor kits, soft armor and hard armor, to support customer armor requirements. Soft armor, which is capable of protecting against all handguns and 9mm sub guns, is used in our ballistic and fragmentation vest, architectural and special application armor lines. Hard armor, which is capable of protecting against rifle fire up to 50cal/12.7mm API, is used in our ballistic chest plate, aircraft, marine and architectural armor lines. Within these two basic kinds of armor, we offer the product lines listed below.

Fixed and Rotary Wing Aircraft Armor Systems

We design and manufacture ballistic armor systems for a wide variety of fixed and rotary wing aircraft. These systems are in the form of kits, with individual contoured panels which cover the entire aircraft's floor, walls, seats, bulkheads, walls, oxygen containers, avionics and doors. All of our ballistic armor kits include a complete installation hardware kit containing all items required for installation.

These kits have been sold to both the original airframe manufacturers and end users worldwide. Armor kits for rotary wing aircraft include Bell Helicopter's B206, B212, B407, B412, B427, and UH-1H; Boeing's CH-46 and CH-47; MD Helicopter's MD 500, MD 600, and MD 900; Agusta Helicopter's A109; Eurocopter's EC-120, EC-135, BK117, and BO-105; Aerospatiale's AS 330, AS 332, and AS 355; Sikorsky's UH-60 and S-61; MIL MI-8 and MI-17; Robinson's R-22 and R-44; and Kaman's K-MAX.

Fixed wing aircraft kits include Lockheed's C-130H, C-130J, and P-3; Boeing's C-17; Alenia's G-222 and C-27J; Ayers' T-65; Rockwell's OV-10; CASA CN 235 and CN 295; and special configurations of the Citation, Beechcraft and Cessna models.

Marine Armor Kits

For the marine market, we manufacture armor kits for the gun mounts on naval ships and riverine patrol boats and armor for patrol boats. We recently provided armor for the bridge and wheelhouse for several police harbor patrol boats.

Ballistic Vests and Plates and Body Armor

We have developed special applications, including the Armourfloat, which to our knowledge is currently the only ballistic/floatation vest approved by the U.S. Coast Guard, ballistic hand held shields and the LEGUARD Tactical Leg Armor, which offers complete front protection for the lower thigh, knee, shin and instep.

Other Armor for Specialty Applications

We also manufacture ballistic and fragmentation blankets and curtains for numerous specialty applications. These applications include operator protection around test equipment; rupture protection of pressure vessels, mechanical failure of production machinery and high pressure piping. Additionally, we have supplied armor for office use in protection of occupants from blast and glass fragments of windows and isolation of security rooms from surrounding environments.

Sales, Marketing and Customers

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

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

We hold exclusive armoring contracts with Israel's sole General Motors and Chevrolet distributors. This means that these distributors will continue to honor the original vehicle warranty on armored versions of vehicles sold by them only if the armoring was done by us.

We are also partners in a joint venture with two prominent Indian companies for the design and manufacture of armored vehicles in India. The joint venture, called Concord Safety Solutions Limited, will offer armored vehicles to the Indian military and paramilitary organizations.

We market our aircraft armor kits directly to both the original airframe manufacturer, such as Alenia, Agusta, Bell-Textron, Boeing, EADS (Eurocopter), Lockheed-Martin and MD Helicopter, as well as, aircraft completion operations and end users worldwide.

At the request of an airframe manufacturer or end user, we send a technical representative to meet the customer at the aircraft to review the layout of areas to be armored, develop templates if required and to determine any unique characteristics that the customer or end user desires incorporated into the armor. After the templates are converted to full size armor mock-up panels, they are taken back to the aircraft for review and approval by either the OEM or the user prior to production. This approach has proven to be the most effective in obtaining both OEM certification of each of our systems and in ensuring that our ballistic armor systems meet or exceed the end users' operational and ballistic demands.

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

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

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

Manufacturing

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

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

Competition

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

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

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

Aircraft armor competition includes LAST Armor (a division of Foster-Miller, Inc.), Simula Inc. (a subsidiary of Armor Holdings, Inc.), and Protective Materials Company (a division of The Protective Group, Inc.). Military vehicle armor competition includes: O’Gara-Hess & Eisenhardt (a subsidiary of Armor Holdings, Inc.), ArmorWorks Harl Facility, Protective Materials Company, and Ceradyne, Inc. Ballistic vests competition includes: Point Blank Body Armor, Inc. (a subsidiary of DHB Industries, Inc.), Second Chance Body Armor, Inc., Protective Materials Company, American Body Armor (a subsidiary of Armor Holdings, Inc.), Protech Armor Systems (a subsidiary of Armor Holdings, Inc.) and Safariland, Ltd. (a subsidiary of Armor Holdings, Inc.). Marine armor competition includes Protective Materials Company. Many of our competitors have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours.

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 2006, 2005 and 2004 revenues from our Battery and Power Systems Division were approximately \$8.6 million, \$9.9 million and \$10.5 million, respectively.

Lithium Batteries and Charging Systems for the Military

INTRODUCTION

We sell lithium batteries and charging systems to the military through our subsidiary Epsilor Electronic Industries, Ltd., an Israeli corporation established in 1985 that we purchased early in 2004.

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

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

PRODUCTS

We currently produce over 50 different products in the following categories:

- Primary batteries;
- Rechargeable batteries;
- Smart chargers;
- State of charge indicators; and
- Control and monitoring battery circuits

Our lithium batteries are based on commercially-available battery cells that we purchase from several leading suppliers, with proprietary energy management circuitry and software. Our battery packs are designed to withstand harsh environments, and have a track record of years of service in armies worldwide.

We produce a wide range of primary batteries based on the following chemistries: lithium sulfur dioxide, lithium manganese dioxide and alkaline. The rechargeable battery chemistries that we employ are: nickel cadmium, nickel metal hydride and lithium-ion. We manufacture single and multi-channel smart chargers for nickel cadmium, nickel metal hydride and lithium-ion batteries.

We have designed a number of sophisticated state of charge indicators. These are employed in our Epsilor products and are also sold as components to other battery pack manufacturers. We also develop and manufacture control systems for high rate primary battery-packs and monitoring systems for rechargeable battery-packs.

MARKETS/APPLICATIONS

Our target markets for our lithium batteries are military and security entities seeking high-end solutions for their power source needs. By their nature, the sell-in cycles are long and the resultant entry barriers are high. This is due to the high cost of developing custom designs and the long period needed to qualify any product for military use.

Our present customers include:

- Armed forces in the Middle East and Asia;
- Military original equipment manufacturers (OEMs); and
- Various battery manufacturers.

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, AEA Battery Systems (a wholly owned subsidiary of AEA Technology plc) in the United Kingdom, which has the majority of the English military market, and Ultralife Batteries, Inc. in the United States. On the primary end of the market there are a host of players who include the cell manufacturers themselves, including Saft S.A. and Ultralife Batteries, Inc.

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

MARKETING

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

MANUFACTURING

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

Zinc-Air Batteries and Chargers for the Military

INTRODUCTION

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

Since 1998 we have received and performed a series of contracts from CECOM to develop and evaluate advanced primary Zinc-Air battery technology, as well as specific battery form factors. Pursuant to these contracts, we developed and began selling in 2002 a 12/24 volt, 800 watt-hour battery pack for battlefield power, which is based on our Zinc-Air battery technology, weighs less than three kilograms (just over six pounds) and has approximately twice the energy capacity per kilogram of the U.S. Army's standard lithium-sulfur dioxide battery packs - the BA-5590/U battery.

In the second half of 2002, our five-year program with CECOM to develop a Zinc-Air battery for battlefield power culminated in the assignment of a National Stock Number and a \$2.5 million delivery order for the newly designated BA-8180/U battery. Subsequent to this initial \$2.5 million delivery order, we received additional follow-on orders from the Army.

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

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

PRODUCTS

Zinc-Air Batteries

BA-8180/U

EFB's Zinc-Air battery packs are lightweight, low-cost primary Zinc-Air batteries with up to twice the energy density (Wh/kg) of primary lithium (LiSO₂) battery packs, which are the most popular batteries used in the US military today. Zinc-Air batteries are inherently safe in storage, transportation, use, and disposal.

The BA-8180/U is a 12/24 volt, 800 watt-hour battery pack approximately the size and weight of a notebook computer. This battery is based on a new generation of lightweight, 30 ampere-hour cells developed by us over the last five years with partial funding by CECOM. Each BA-8180/U battery pack contains 24 cells.

The battery has specific energy of up to 265 Wh/kg, which is substantially higher than that of any competing disposable battery available to the defense and security industries. By way of comparison, the BA-5590/U, a popular LiSO₂ battery pack, has only 170 Wh/kg. Specific energy, or energy per unit of weight, translates into longer operating times for battery-powered electronic equipment for the same battery carry weight, and greater portability as well. Because of lower cost per watt-hour, the BA-8180/U can provide substantial cost savings to the Army when deployed for longer missions, even for applications that are not man-portable.

CECOM has assigned a National Stock Number (NSN) to our Zinc-Air battery, making it possible to order and stock the battery for use by the Armed Forces. CECOM also assigned the designation BA-8180/U to our Zinc-Air battery, the first time an official US Army battery designation was ever assigned to a Zinc-Air battery.

Based on extensive contacts with the US and foreign military agencies, we believe that a significant market exists for the BA-8180/U both in the US Armed Forces and abroad.

8140/U

The BA-8140/U is a new product that has recently been qualified and that has already generated initial sales of over 5,000 batteries from CECOM. The BA-8140/U is a smaller version of our 8180/U, and was developed at the request of CECOM for powering handheld military radios for extended periods. It is approximately half the size, weight and capacity of our 8180/U. CECOM has assigned a National Stock Number (NSN) to our BA-8140/U Zinc-Air battery as well.

Adapters

The BA-8180/U is a battery, but in order to connect it or the BA-8140/U to a specific piece of equipment, an adapter must be used. In order to provide compatibility between the battery and various items of military equipment, we supply various types of electrical interface adapters for each specific piece of military equipment, including adapters for the SatCom Radio family (AN/PSC-5, AN/PRC-117F, AN/PRC-150 HF), AN/PRC-119 SINCGARS, SINCGARS ASIP, AN/PRC-148 MBITR tactical radio sets, and a generic interface for items of equipment that were designed to interface with a BA-5590 or equivalent battery. Each of these interfaces was also assigned a national stock number (NSN) by CECOM. In addition, we have recently qualified additional electrical interfaces and have internal capabilities needed to quickly develop and manufacture additional adapters as needed by customers. These address various applications, including other radios, night vision, missile launchers and chemical detectors.

Hybrids

We have also developed interface adapters for other items of equipment which require higher power than the BA-8180/U can provide by itself. For example, we have developed a hybrid battery system comprising a BA-8180/U battery pack and two small rechargeable lead-acid packs. Even with the weight of the lead-acid batteries, this hybrid system powers a satellite communications terminal for significantly longer than an equivalent weight of BA-5590 LiSO₂ battery packs. We have also developed a hybrid system that incorporates ultracapacitors. We received our first orders for this man-portable hybrid power source from the U.S. Army late in 2005.

Portable Power Systems

Field Chargers

One critical need for soldiers is the ability to recharge batteries in the field. Rather than take multiple rechargeable batteries for long missions at significant cost and weight, a preferred configuration is to continuously charge one rechargeable battery while using a second to power a soldier's device(s). The key enabling technologies for such an architecture are (a) high energy-density storage devices, (b) efficient, ergonomically-friendly forward field charging devices, and (c) effective power connectivity to various pieces of a soldier's gear. Given the extremely high energy density of our Zinc-Air battery technology (almost twice that of lithium batteries), our captive electronics capabilities, and our core competencies in custom power adapters, we believe that EFB is in a unique position to marry these enabling technologies and deliver usable forward field charging solutions to the military market space. Current projects include body-worn Zinc-Air batteries used in hybrid with lithium-ion batteries in key applications as well as utilization of Zinc-Air batteries as forward field chargers for lithium-ion batteries. In both application scenarios, the soldier's total battery carry weight is halved.

Next Generation Zinc-Air Products and Systems

A fourth generation of Zinc-Air products is being developed for applications where volume is critical, and/or where the power-to-energy ratio needs to be significantly higher than that of the BA-8180/U. These "Gen4" Zinc-Air products consist of an air cathode folded around a zinc electrode. Gen4 was originally developed for the Marine Corps Dragon Eye UAV, which requires up to 200 W from a battery that fits into its sleek fuselage and weighs less than one kilogram. Along the way, it was recognized that the Gen4 design could be applied to other battery missions requiring high power as well as energy density, such as the Land Warrior soldier system, where up to 750 Wh of energy are required for a 24-hour mission. For these systems, the battery currently limits functionality, and we believe Gen4 Zinc-Air is an enabling technology for such extended missions. Through December 31, 2006, we were awarded an aggregate of \$2.8 million of congressional funds and CECOM funding for a three-phase BAA (Broad Agency Announcement, which is a simplified form of government solicitation for basic research and development) to develop this technology.

Body-Wearable Systems

We believe that our Gen4 Zinc-Air battery technology enables much more systemic approaches to solving the soldier's portable power puzzle. Programs currently include body power harnesses powered by a single, lightweight battery that replaces multiple, heavier batteries. Such solutions significantly cut the soldier's battery carry weight and battery cost as well as add a virtually priceless factor - convenience. Convenience for a soldier in combat - not having to change batteries from multiple equipment during a mission - can often make or break the success of the mission, and can even be a life-saving factor.

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, including:

- Tactical radios
- SIGINT systems
- Training systems
- SATCOM radios
- Nightscope power
- Guidance systems
- Surveillance systems
- Sensors

CUSTOMERS

The principal customers for our Zinc-Air batteries during 2006 were the U.S. Army's Communications-Electronics Command (CECOM) and the Defense Logistics Agency (DLA). In addition, we continue to further penetrate Special Forces and other specific U.S. military units with direct sales.

COMPETITION

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

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

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

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

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

Lifejacket Lights

PRODUCTS

In 1996, we began to produce and market lifejacket lights built with our patented magnesium-cuprous chloride batteries, which are activated by immersion in water (water-activated batteries), for the aviation and marine safety and emergency markets. Additionally, in 2004 we added two new models to our line of lifejacket light, based on lithium batteries. At present we have a product line consisting of seven lifejacket light models, five for use with marine life jackets and two for use with aviation life vests, all of which work in both freshwater and seawater. Each of our lifejacket lights is certified for use by relevant governmental agencies under various U.S. and international regulations. We manufacture, assemble and package all our lifejacket lights through EFL in our factory in Beit Shemesh, Israel.

MARKETING

We market our marine safety products through our own network of distributors in Europe, the United States, Asia and Oceania. We market our lights to the commercial aviation industry through The Burkett Company of Houston, Texas, which 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, 2006, 2005 and 2004, our backlog for the following years was approximately \$41.3 million, \$18.3 million and \$25.0 million, respectively, divided among our divisions as follows:

Division	2006	2005	2004
Simulation and Training Division	\$ 11,518,000	\$ 9,379,000	\$ 12,691,000
Battery and Power Systems Division	9,213,000	4,523,000	8,325,000
Armor Division	20,582,000	4,440,000	4,002,000
TOTAL:	\$ 41,313,000	\$ 18,342,000	\$ 25,018,000

Major Customers

During 2006, 2005 and 2004, including all of our divisions, various branches of the United States military accounted for approximately 49%, 33% and 13% 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, 2006, 2005 and 2004, our gross research and product development expenditures were approximately \$1.6 million, \$1.3 million and \$1.7 million, respectively.

EFL has certain contingent royalty obligations to the Office of the Chief Scientist of the Israel Ministry of Industry and Trade and the Israel-U.S. Binational Industrial Research and Development Foundation (BIRD, which apply (in respect of continuing operations) only to our inactive Electric Vehicle program. As of December 31, 2006, our total outstanding contingent liability in this connection was approximately \$11.0 million.

Employees

As of February 28, 2007, we had 342 full-time employees worldwide. Of these employees, 3 hold doctoral degrees and 36 hold other advanced degrees. Of the total, 59 employees were engaged in product research and development, 202 were engaged in production and operations, 19 were engaged in marketing and sales, and 62 were engaged in general and administrative functions. Our success will depend in large part on our ability to attract and retain skilled and experienced employees.

We and our employees are not parties to any collective bargaining agreements. However, as certain of our employees are located in Israel and employed by EFL, MDT or Epsilor, certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Manufacturers' Association of Israel) are applicable to EFL's, MDT's and Epsilor's employees by order (the "Extension Order") of the Israeli Ministry of Labor and Welfare. These provisions principally concern the length of the work day and the work week, minimum wages for workers, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment, including certain automatic salary adjustments based on changes in the Israeli CPI.

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 fund our ongoing severance obligations by making monthly payments to approved severance funds or insurance policies. In addition, Israeli employees and employers are required to pay specified sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Since January 1, 1995, such amounts also include payments for national health insurance. The payments to the National Insurance Institute are approximately 15.6% of wages, of which the employee contributes approximately 62% and the employer contributes approximately 38%. The majority of the permanent employees of EFL, about a quarter of the permanent employees of MDT, and one of the permanent employees of Epsilor, are covered by "managers' insurance," which provides life and pension insurance coverage with customary benefits to employees, including retirement and severance benefits. We contribute 14.33% to 15.83% (depending on the employee) of base wages to such plans and the permanent employees contribute 5% of their base wages.

In 1993, an Israeli court held that companies that are subject to the Extension Order are required to make pension contributions exclusively through contributions to Mivtachim Social Institute of Employees Ltd., a pension fund managed by the Histadrut. We subsequently reached an agreement with Mivtachim with respect to providing coverage to certain production employees and bringing ourselves into conformity with the court decision. The agreement does not materially increase our pension costs or otherwise materially adversely affect its operations. Mivtachim has agreed not to assert any claim against us with respect to any of our past practices relating to this matter. Although the arrangement does not bind employees with respect to instituting claims relating to any nonconformity by us, we believe that the likelihood of the assertion of claims by employees is low and that any potential claims by employees against us, if successful, would not result in any material liability to us.

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 each of the initial public offering of our common stock in February 1994; through subsequent public and private offerings of our common stock and equity and debt securities convertible or exercisable into shares of our common stock; research contracts and supply contracts; funds received under research and development grants from the Government of Israel; and sales of products that we and our subsidiaries manufacture. We have incurred significant net losses since our inception. Additionally, as of December 31, 2006, we had an accumulated deficit of approximately \$158.6 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 substantially reduced certain senior employee salaries during 2005, cut directors' fees, and 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.

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 to market our products and develop and market 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, lines of credit and anticipated additions to paid-in capital should be sufficient to satisfy our current estimated cash requirements through the next twelve months. 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. Moreover, the issuance by us of additional debt or equity is severely restricted by the terms of our existing indebtedness which is payable during 2007. 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 certificated indebtedness (short and long term) aggregated approximately \$6.1 million principal amount as of December 31, 2006 (not including trade payables, other account payables and accrued severance pay), of which \$2.6 million is in respect of our convertible notes due in 2007 and \$3.5 million is 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.

The agreements governing the terms of our notes that mature during 2007 contain numerous affirmative and negative covenants that limit the discretion of our management with respect to certain business matters and place restrictions on us, including obligations on our part to preserve and maintain our assets and restrictions on our ability to incur or guarantee debt, to merge with or sell our assets to another company, and to make significant capital expenditures without the consent of the note holders. Our ability to comply with these and other provisions of such agreements may be affected by changes in economic or business conditions or other events beyond our control.

Failure to comply with the terms of our 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 the notes and the acceleration of debt under other instruments evidencing indebtedness that may contain cross-acceleration or cross-default provisions. If the indebtedness under the notes or other indebtedness were to be accelerated, there can be no assurance that our future cash flow or assets would be sufficient to repay in full such indebtedness.

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

Our ability to make payments on and to refinance 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.

The payment by us of our secured convertible notes in stock or the conversion of such notes by the holders could result in substantial numbers of additional shares being issued, with the number of such shares increasing if and to the extent our market price declines, diluting the ownership percentage of our existing stockholders.

In September 2005, we issued \$17.5 million in secured convertible notes due March 31, 2008. The Notes are convertible at the option of the holders at a fixed conversion price of \$14.00. We must repay the remaining \$2.6 million in principal amount of the notes over a period of two and one-half years, with the principal amount being amortized in twelve payments payable at our option in cash and/or stock, by requiring the holders to convert a portion of their Notes into shares of our common stock, provided certain conditions are met. The failure to meet such conditions could make us unable to pay our notes, causing us to default. If the price of our common stock is above \$14.00, the holders of our notes will presumably convert their notes to stock when payments are due, or before, resulting in the issuance of additional shares of our common stock.

One-twelfth of the principal amount of the Notes is payable on each of January 31, 2006, March 31, 2006, May 31, 2006, July 31, 2006, September 30, 2006, November 30, 2006, May 31, 2007, July 31, 2007, September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008. We paid all of the January 31, 2006, March 31, 2006, May 31, 2006, July 31, 2006 and September 30, 2006, and most of the November 30, 2006 and January 31, 2007, payments in stock by requiring the holders to convert a portion of their Notes. Additionally, with the agreement of the holders of our Notes, we prepaid the payments of September 30, 2007, November 30, 2007, January 31, 2008, and March 31, 2008, as well as a small portion of the payment due July 31, 2007, in stock by requiring the holders to convert a portion of their Notes, leaving only the payments of May 31, 2007 and most of the payment of July 31, 2007 remaining. In the event we continue to elect to make payments of principal on our convertible notes in stock by requiring the holders to convert a portion of their Notes, either because our cash position at the time makes it necessary or we otherwise deem it advisable, the price used to determine the number of shares to be issued on conversion will be calculated using an 8% discount to the average trading price of our common stock during 17 of the 20 consecutive trading days ending two days before the payment date. Accordingly, the lower the market price of our common stock at the time at which we make payments of principal in stock, the greater the number of shares we will be obliged to issue and the greater the dilution to our existing stockholders.

In either case, the issuance of the additional shares of our common stock could adversely affect the market price of our common stock.

We can require the holder of our Notes to convert a portion of their Notes into shares of our common stock at the time principal payments are due only if such shares are registered for resale and certain other conditions are met. If our stock price were to decline, we might not have a sufficient number of shares of our stock registered for resale in order to continue requiring the holders to convert a portion of their Notes. As a result, we would need to file an additional registration statement with the SEC to register for resale more shares of our common stock in order to continue requiring conversion of our Notes upon principal payment becoming due. Any delay in the registration process, including through routine SEC review of our registration statement or other filings with the SEC, could result in our having to pay scheduled principal repayments on our Notes in cash, which would negatively impact our cash position and, if we do not have sufficient cash to make such payments in cash, could cause us to default on our Notes.

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

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

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

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

We may not be successful in operating our acquired businesses.

Prior to the acquisitions of IES and MDT in 2002 and the acquisitions of FAAC and Epsilon in January 2004 and AoA in August 2004, our primary business was the marketing and sale of products based on primary and refuelable Zinc-Air battery technology and advancements in battery technology for defense and security products and other military applications, electric vehicles and consumer electronics. As a result of our acquisitions, a substantial component of our business is the marketing and sale of high-tech multimedia and interactive training solutions and sophisticated lightweight materials and advanced engineering processes used to armor vehicles. These are relatively new businesses for us and our management group has limited experience operating these types of businesses. Although we have retained our acquired companies' management personnel, we cannot assure that such personnel will continue to work for us or that we will be successful in managing these new businesses. If we are unable to successfully operate these new businesses, our business, financial condition and results of operations could be materially impaired.

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

As of December 31, 2004, we had recorded goodwill of \$39.7 million. On January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement, at least annually thereafter, and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units. We performed the required annual impairment test of goodwill, based on our projections and using expected future discounted operating cash flows. As of December 31, 2005, we identified in AoA an impairment of goodwill in the amount of \$11.8 million. As of December 31, 2006, we identified in AoA an additional impairment of goodwill in the amount of \$316,000.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of 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. As of December 31, 2004, we identified an impairment of other intangible assets identified with the IES acquisition and, as a result, we recorded an impairment loss in the amount of \$320,000. As of December 31, 2005, we identified an impairment of other intangible assets identified with the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$499,000.

We will continue to assess the fair value of our goodwill annually or earlier if events occur or circumstances change that would more likely than not reduce the fair value of our goodwill below its carrying value. These events or circumstances would include a significant change in business climate, including a significant, sustained decline in an entity's market value, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business, or other factors. If we determine that significant impairment has occurred, we would be required to write off the impaired portion of goodwill. Impairment charges could have a material adverse effect on our financial condition and results.

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

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

We may consider acquisitions in the future to grow our business, and such activity could subject us to various risks.

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

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

We may not successfully integrate our prior acquisitions.

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

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

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

As a result of our acquisitions, we have experienced a period of significant growth and development activity which has placed a significant strain on our personnel and resources. Our activity has resulted in increased levels of responsibility for both existing and new management personnel. Many of our management personnel have had limited or no experience in managing growing companies. We have sought to manage our current and anticipated growth through the recruitment of additional management and technical personnel and the implementation of internal systems and controls. However, our failure to manage growth effectively could adversely affect our results of operations.

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

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

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

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

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

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

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

Our battery technology competes with other battery technologies, as well as other Zinc-Air technologies. The competition in this area of our business consists of development stage companies, major international companies and consortia of such companies, including battery manufacturers, automobile manufacturers, energy production and transportation companies, consumer goods companies and defense contractors.

Various battery technologies are being considered for use in 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.

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 MDT and Epsilon subsidiaries, and the loss of the services of one or more of these persons could adversely affect us. We are especially dependent on the services of our Chairman and Chief Executive Officer, Robert S. Ehrlich, and our President and Chief Operating Officer, Steven Esses. The loss of either Mr. Ehrlich or Mr. Esses could have a material adverse effect on us. We are party to an employment agreement with Mr. Ehrlich, which agreement expires at the end of 2009, and an employment agreement with Mr. Esses, which agreement expires at the end of 2008. We do not have key-man life insurance on either Mr. Ehrlich or Mr. Esses.

Payment of severance or retirement benefits earlier than anticipated could strain our cash flow.

Our Chairman and Chief Executive Officer, Robert S. Ehrlich, and our President and Chief Operating Officer, Steven Esses, both have employment agreements that provide for substantial severance payments and retirement benefits. We are required to fund a certain portion of these payments according to a predetermined schedule. Should Mr. Ehrlich or Mr. Esses leave our employ under circumstances entitling them to severance or retirement benefits, or become disabled or die, before we have funded these payments, the need to pay these severance or retirement benefits ahead of their anticipated schedule could put a strain on our cash flow and have a material adverse effect on our financial condition.

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 2006, 2005 and 2004, without taking account of revenues derived from discontinued operations, 25%, 21% and 19%, 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.

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

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

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 the customers of IES, FAAC and AoA to date have been in the public sector of the U.S., including the federal, state and local governments, and in the public sectors of a number of other countries, and most of MDT's customers have been in the public sector in Israel, in particular the Ministry of Defense. Additionally, all of EFB's sales to date of battery products for the military and defense sectors have been in the public sector in the United States. A significant decrease in the overall level or allocation of defense or law enforcement spending in the U.S. or other countries could reduce our revenues and have a material adverse effect on our future results of operations and financial condition.

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.

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.

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.

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

Some of our contracts are fixed-price contracts under which we bear the risk of any cost overruns. Our profits are adversely affected if our costs under these contracts exceed the assumptions that we used in bidding for the contract. Often, we are required to fix the price for a contract before we finalize the project specifications, which increases the risk that we will mis-price these contracts. The complexity of many of our engagements makes accurately estimating our time and resources more difficult. 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 of several of our significant contracts or nonrenewal of several of our significant contracts, could result in significant revenue shortfalls.

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

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

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.

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 (formerly known as the Nasdaq National Market), on which our stock is currently listed, and the Nasdaq Capital Market (formerly known as the Nasdaq SmallCap Market)) is the maintenance of a \$1.00 bid price. Our stock price was below \$1.00 between August 15, 2005 and June 20, 2006; however, on June 21, 2006, we effected a one-for-fourteen reverse stock split, which brought the bid price of our common stock back over \$1.00. If our bid price were to go and remain below \$1.00 for 30 consecutive business days, Nasdaq could notify us of our failure to meet the continued listing standards, after which we would have 180 calendar days to correct such failure or be delisted from the Nasdaq Global Market. In addition, we may be unable to satisfy the other continued listing requirements.

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. 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.

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

Sales of a substantial number of shares of common stock into the public market, or the perception that those sales could occur, could adversely affect our stock price or could impair our ability to obtain capital through an offering of equity securities. As of February 28, 2007, we had 11,983,576 shares of common stock issued and outstanding. Of these shares, most are freely transferable without restriction under the Securities Act of 1933 or pursuant to effective resale registration statements, and a substantial portion of the remaining shares may be sold subject to the volume restrictions, manner-of-sale provisions and other conditions of Rule 144 under the Securities Act of 1933.

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

As of December 31, 2006, there were outstanding warrants to purchase a total of 1,049,709 shares of our common stock at a weighted average exercise price of \$14.03 per share, options to purchase a total of 1,535,829 shares of our common stock at a weighted average exercise price of \$8.33 per share, of which 535,097 were vested, at a weighted average exercise price of \$8.38 per share, and outstanding notes convertible into a total of 185,793 shares of our common stock at a weighted average conversion price of \$14.00 per share. Holders of our options, warrants and convertible debt will probably exercise or convert them only at a time when the price of our common stock is higher than their respective exercise or conversion prices. Accordingly, we may be required to issue shares of our common stock at a price substantially lower than the market price of our stock. This could adversely affect our stock price. In addition, if and when these shares are issued, the percentage of our common stock that existing stockholders own will be diluted.

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

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

- 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.

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

Israel-Related Risks

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

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

Historically, Arab states have boycotted any direct trade with Israel and to varying degrees have imposed a secondary boycott on any company carrying on trade with or doing business in Israel. Although in October 1994, the states comprising the Gulf Cooperation Council (Saudi Arabia, the United Arab Emirates, Kuwait, Dubai, Bahrain and Oman) announced that they would no longer adhere to the secondary boycott against Israel, and Israel has entered into certain agreements with Egypt, Jordan, the Palestine Liberation Organization and the Palestinian Authority, Israel has not entered into any peace arrangement with Syria or Lebanon. Moreover, since September 2000, there has been a significant deterioration in Israel’s relationship with the Palestinian Authority, and a significant increase in terror and violence. Efforts to resolve the problem have failed to result in an agreeable solution. Israel withdrew unilaterally from the Gaza Strip and certain areas in northern Samaria in 2005. It is unclear what the long-term effects of such disengagement plan will be. The election of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council has created additional unrest and uncertainty.

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 hold.

Continued hostilities between Israel and its neighbors and any failure to settle the conflict could have a material adverse effect on our business and us. Moreover, the current political and security situation in the region has already had an adverse effect on the economy of Israel, which in turn may have an adverse effect on us.

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

We are organized under the laws of the State of Delaware and will be subject to service of process in the United States. However, approximately 13% of our assets are located outside the United States. In addition, two of our directors and most of our executive officers are residents of Israel and a portion of the assets of such directors and executive officers are located outside the United States.

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 2006, the inflation adjusted NIS appreciated against the dollar.

Some of our agreements are governed by Israeli law.

Israeli law governs some of our agreements, such as our lease agreements on our subsidiaries' premises in Israel, and the agreements pursuant to which we purchased IES, MDT and Epsilor. While Israeli law differs in certain respects from American law, we do not believe that these differences materially adversely affect our rights or remedies under these agreements.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our primary executive offices are located in FAAC's offices, consisting of approximately 17,800 square feet of office and warehouse space in Ann Arbor, Michigan, pursuant to a lease expiring in January 2008. FAAC has also leased 10,900 square feet of office and warehouse space in Ann Arbor, Michigan pursuant to a lease beginning in June 2006 and expiring in January 2008, for use by IES.

EFB, MDT Armor and AoA all operate out of our Auburn, Alabama facilities, constituting approximately 30,000 square feet, which is leased from the City of Auburn through December 2008. Additionally, we have purchased 16,700 square feet of space in Auburn for approximately \$1.1 million pursuant to a seller-financed secured purchase money mortgage. Half the mortgage is payable over ten years in equal monthly installments based on a 20-year amortization of the full principal amount, and the remaining half is payable at the end of ten years in a balloon payment.

Our management and administrative facilities and research, development and production facilities for the manufacture and assembly of our Survivor Locator Lights, constituting approximately 18,300 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, 2007; we have the ability to terminate the lease every two years upon three months' written notice. Moreover, we may terminate the lease at any time upon twelve months written notice. Most of the members of our senior management, including our Chief Executive Officer and our Chief Operating Officer, work extensively out of our Beit Shemesh facility. Our Chief Financial Officer works out of our Ann Arbor, Michigan facility.

Our Epsilor subsidiary rents approximately 19,000 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.

Our MDT subsidiary rents approximately 20,000 square feet of office space in Lod, Israel, near Ben-Gurion International airport (within Israel's pre-1967 borders) pursuant to a lease renewable on an annual basis.

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, except as follows:

NAVAIR Litigation

In December 2004, AoA filed an action in the United States Court of Federal Claims against the United States Naval Air Systems Command (NAVAIR), seeking approximately \$2.2 million in damages for NAVAIR's alleged improper termination of a contract for the design, test and manufacture of a lightweight armor replacement system for the United States Marine Corps CH-46E rotor helicopter. NAVAIR, in its answer, counterclaimed for approximately \$2.1 million in alleged reprourement and administrative costs.

Class Action Litigation

We have learned that on March 23, 2007, a purported class action complaint (the "Complaint") was apparently filed in the United States District Court for the Eastern District of Michigan against us and certain of our officers and directors. Although we have yet to be served with a copy of the Complaint, the Complaint apparently seeks class status on behalf of all persons who purchased our securities between March 31, 2005 and November 14, 2005 (the "Period") and alleges violations by us and certain of our officers and directors of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder, primarily related to our acquisition of Armour of America in 2005 and certain public statements made by us with respect to our business and prospects during the Period. The Complaint also alleges that we did not have adequate systems of internal operational or financial controls, and that our financial statements and reports were not prepared in accordance with GAAP and SEC rules. The Complaint seeks an unspecified amount of damages.

Although the ultimate outcome of this matter cannot be determined with certainty, we believe that the allegations stated in the Complaint are without merit and we and our officers and directors named in the Complaint intend to defend ourselves vigorously against such allegations

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the Nasdaq Global Market (formerly known as the Nasdaq National 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/National Market System; such prices have been adjusted to reflect the one-for-fourteen reverse stock split effected on June 21, 2006:

Year Ended December 31, 2006	High	Low
Fourth Quarter	\$ 3.69	\$ 1.43
Third Quarter	\$ 3.92	\$ 1.88
Second Quarter	\$ 8.12	\$ 2.25
First Quarter	\$ 8.96	\$ 5.18
Year Ended December 31, 2005	High	Low
Fourth Quarter	\$ 10.64	\$ 5.04
Third Quarter	\$ 16.66	\$ 9.80
Second Quarter	\$ 20.44	\$ 14.00
First Quarter	\$ 24.92	\$ 17.64

As of February 28, 2007 we had approximately 318 holders of record of our common stock.

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.

ITEM 6. SELECTED FINANCIAL DATA

The selected financial information set forth below with respect to the consolidated statement of operations for the fiscal year ended December 31, 2006, and with respect to the balance sheet at the end of such fiscal year has been derived from our consolidated financial statements (and schedules) audited by BDO Seidman, LLP, independent registered public accounting firm.

The selected financial information set forth below with respect to the consolidated statement of operations for each of the four fiscal years in the period ended December 31, 2005, and with respect to the balance sheets at the end of each such fiscal year has been derived from our consolidated financial statements (and schedules) audited by Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, independent registered public accounting firm.

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

The Consolidated Financial Statements at December 31, 2003 and for the year then ended have been restated.

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

	Year Ended December 31,				
	2002	2003**	2004	2005	2006
	(dollars in thousands, except per share data)				
Statement of Operations Data:					
Revenues	\$ 6,407	\$ 17,326	\$ 49,954	\$ 49,045	\$ 43,120
Research and development expenses and costs of revenues, exclusive of amortization of intangibles	5,108	12,141	35,742	35,684	34,095
Selling, general and administrative expenses and their impairment and amortization of intangible assets	5,982	10,255	18,394	34,662	17,577
Operating loss	(4,683)	(5,070)	(4,182)	(21,301)	(8,551)
Other income	-	-	-	339	361
Financial income (expenses), net	100	4,039	4,229	(2,706)	(7,520)
Loss before minority interest in (loss) earnings of subsidiary and tax expenses	(4,583)	(9,109)	(8,411)	(23,668)	(15,709)
Taxes on income	-	(396)	(586)	(237)	(232)
Gain (loss) from affiliated company	-	-	-	(75)	355
Minority interest in (loss) earnings of subsidiary	(355)	157	(45)	57	17
Loss from continuing operations	(4,938)	(9,348)	(9,042)	(23,923)	(15,569)
Income (loss) from discontinued operations	(13,566)	110	-	(120)	-
Net loss for the period	(18,504)	(9,238)	(9,042)	(24,043)	(15,569)
Deemed dividend to certain stockholders of common stock	-	(350)	(3,329)	-	(434)
Net loss attributable to stockholders of common stock	\$ (18,504)	\$ (9,588)	\$ (12,371)	\$ (24,043)	\$ (16,003)
Basic and diluted net loss per share from continuing operations	\$ (2.13)	\$ (3.41)	\$ (2.48)	\$ (4.07)	\$ (1.87)
Loss per share for combined operations	\$ (8.00)	\$ (3.45)	\$ (2.48)	\$ (4.09)	\$ (1.87)
Weighted average number of common shares used in computing basic and diluted net loss per share (in thousands)	2,313	2,778	4,995	5,872	8,569

	As At December 31,				
	2002	2003**	2004	2005	2006
	(dollars in thousands)				
Balance Sheet Data:					
Cash, cash equivalents, investments in marketable debt					
securities and restricted collateral deposits	\$ 2,091	\$ 14,391	\$ 13,832	\$ 10,864	\$ 3,059
Receivables and other assets*	7,895	8,898	25,746	29,166	28,051
Property and equipment, net of depreciation	2,555	2,293	4,601	4,253	3,741
Goodwill and other intangible assets, net	7,522	7,440	54,113	40,586	40,217
Total assets	\$ 20,063	\$ 33,022	\$ 98,292	\$ 84,869	\$ 75,068
Current liabilities*	\$ 7,272	\$ 6,710	\$ 26,381	\$ 26,317	\$ 15,738
Long-term liabilities***	3,753	4,686	6,438	12,287	4,370
Stockholders' equity	9,038	21,626	65,473	46,265	54,960
Total liabilities and stockholders equity*	\$ 20,063	\$ 33,022	\$ 98,292	\$ 84,869	\$ 75,068

* Includes assets and liabilities, as applicable, from discontinued operations.

** Restated.

*** Includes minority interest.

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 three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. We operate in three business units:

- we develop, manufacture and market advanced high-tech multimedia and interactive digital solutions for use-of-force and driving training of military, law enforcement, security and other personnel (our **Simulation and Training Division**);

- we provide aviation armor kits and we utilize sophisticated lightweight materials and advanced engineering processes to armor vehicles (our **Armoring Division**); and
- we develop, manufacture and market primary Zinc-Air batteries, rechargeable batteries and battery chargers for defense and security products and other military applications (our **Battery and Power Systems Division**).

During 2004, we acquired three new businesses: FAAC Corporation, located in Ann Arbor, Michigan, which provides simulators, systems engineering and software products to the United States military, government and private industry (which we have placed in our Simulation and Training Division); Epsilor Electronic Industries, Ltd., located in Dimona, Israel, which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia (which we have placed in our Battery and Power Systems Division); and Armour of America, Incorporated, located in Auburn, Alabama, which manufactures aviation armor both for helicopters and for fixed wing aircraft, marine armor, personnel armor, armoring kits for military vehicles, fragmentation blankets and a unique ballistic/flotation vest (ArmourFloat) that is U.S. Coast Guard-certified, which we have placed in our Armor Division. Our financial results for 2004 do not include the activities of FAAC, Epsilor or AoA for the full year and therefore are not directly comparable to our financial results for 2005.

Critical Accounting Policies

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

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

Revenue Recognition

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

A portion of our revenue is derived from license agreements that entail the customization of FAAC's simulators to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with Statement of Position 81-1 "Accounting for Performance of Construction - Type and Certain Production - Type Contracts" 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 SOP 97-2, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants and as amended by SOP 98-4 and SOP 98-9 and related interpretations. We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

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

Stock Based Compensation

We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R) ("SFAS No. 123(R)", "Share-Based Payment," using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

Allowance for Doubtful Accounts

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

Accounting for Income Taxes

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

We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("Statement 109"), involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. We do not provide for U.S. federal income taxes on the undistributed earnings of our foreign subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

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

Inventories

Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, valuation of existing inventory, as well as product lifecycle and product development plans. The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also used for our short-term manufacturing plans. Inventory reserves are also provided to cover risks arising from slow-moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. We may be required to record additional inventory write-down if actual market conditions are less favorable than those projected by our management. For fiscal 2006, no significant changes were made to the underlying assumptions related to estimates of inventory valuation or the methodology applied.

Goodwill

Under Financial Accounting Standards Board Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS 142.

During 2005, we performed an impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows, as a response to several factors, including without limitation the reduced sales in AoA (a component of our Armor Division), the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA and us, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular - specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), and the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, the appropriation of substantial funds earmarked for defense was delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, we identified in AoA an impairment of goodwill in the amount of \$11,757,812.

In connection with our acquisition of AoA, we have a contingent earnout obligation in an amount equal to the revenues realized by us from certain specific programs that were identified by us and the former stockholder of AoA as appropriate targets for revenue increases. The earnout provides that if AoA receives certain types of orders from certain specific customers prior to December 31, 2006 ("Additional Orders"), then upon shipment of goods in connection with such Additional Orders, the former stockholder of AoA will be paid an earnout based on revenues, up to a maximum of an additional \$6.0 million. As of December 31, 2006, we had reduced the \$3.0 million escrow held by the seller of AoA by \$1.5 million for a putative claim against such escrow in respect of such earnout obligation.

We determine fair value using a discounted cash flow analysis. This type of analysis requires us to make assumptions and estimates regarding industry economic factors and the profitability of future business strategies. 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.

Other Intangible Assets

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

The determination of the value of such intangible assets requires us to make assumptions regarding future business conditions and operating results in order to estimate future cash flows and other factors to determine the fair value of the respective assets. If these estimates or the related assumptions change in the future, we could be required to record additional impairment charges. As of December 31, 2004, we identified an impairment of the technology previously purchased from Bristlecone and, as a result, we recorded an impairment loss in the amount of \$320,279. As of December 31, 2005, we identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$498,944. We reduced the \$3.0 million escrow held by the seller of AoA by an additional \$316,000 in 2006 for a putative claim in respect of an earnout obligation, which was charged as an impairment of goodwill.

Contingencies

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

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

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

Warranty Reserves

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

Functional Currency

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

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

Executive Summary

Divisions and Subsidiaries

We operate primarily as a holding company, through our various subsidiaries, which we have organized into three divisions. Our divisions and subsidiaries (all 100% owned, unless otherwise noted) are as follows:

- Our ***Simulation and Training Division***, located in Ann Arbor, Michigan, consisting of:
 - FAAC Incorporated, which provides simulators, systems engineering and software products to the United States military, government and private industry (“FAAC”); and
 - IES Interactive Training, Inc., which provides specialized “use of force” training for police, security personnel and the military (“IES”).
- Our ***Armor Division***, consisting of:
 - MDT Protective Industries, Ltd., located in Lod, Israel, which specializes in using state-of-the-art lightweight ceramic materials, special ballistic glass and advanced engineering processes to fully armor vans and SUVs, and is a leading supplier to the Israeli military, Israeli special forces and special services (“MDT”) (75.5% owned);

- MDT Armor Corporation, located in Auburn, Alabama, which conducts MDT's United States activities ("MDT Armor") (88% owned); and
- Armour of America, located in Auburn, Alabama, which provides ballistic armor kits for rotary and fixed wing aircraft, marine armor, personnel armor, military vehicles and architectural applications, including both the LEGUARD Tactical Leg Armor and the Armourfloat Ballistic Floatation Device, which is a unique vest that is certified by the U.S. Coast Guard ("AoA").

➤ Our **Battery and Power Systems Division**, consisting of:

- Epsilor Electronic Industries, Ltd., located in Dimona, Israel (in Israel's Negev desert area), which develops and sells rechargeable and primary lithium batteries and smart chargers to the military and to private industry in the Middle East, Europe and Asia ("Epsilor");
- Electric Fuel Battery Corporation, located in Auburn, Alabama, which manufactures and sells Zinc-Air batteries and battery chargers for the military, focusing on applications that demand high energy and light weight ("EFB"); and
- Electric Fuel (E.F.L.) Ltd., located in Beit Shemesh, Israel, which produces water-activated lifejacket lights for commercial aviation and marine applications, focusing on obtaining and implementing demonstration projects in the U.S. and Europe ("EFL").

Overview of Results of Operations

We incurred significant operating losses for the years ended December 31, 2006, 2005 and 2004. 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.

In 2005 our net loss increased to \$23.9 million on revenues of \$49.0 million from \$9.0 million on revenues of \$50.0 million in 2004. About half of the 2005 loss was the result of impairments during 2005 of goodwill and other intangible assets in connection with our AoA subsidiary; the remainder of the increase in net loss was attributable to the factors cited below. In 2006, our net loss decreased to \$15.6 million on revenues of \$43.1 million.

A portion of our operating loss during 2006, 2005 and 2004 arose as a result of non-cash charges. In addition to the charges in respect of write-offs of goodwill and other intangible assets described under "Critical Accounting Policies - Goodwill," above, these charges were primarily related to our acquisitions, financings and issuances of restricted shares and options to employees. Because we anticipate continuing certain of these activities during 2007, we 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 will continue during 2007. We are required to review intangible assets for impairment whenever events or changes in circumstances indicate that carrying amount of the assets may not be recoverable. If we determine, through the impairment review process, that intangible asset has been impaired, we must record the impairment charge in our statement of operations.

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

As a result of the application of the above accounting rule, we incurred non-cash charges for amortization of intangible assets in 2006, 2005 and 2004 in the amount of \$1.9 million, \$3.1 million and \$2.8 million, respectively. In addition, we incurred non-cash charges for impairment of goodwill and other intangible assets in the amount of \$12.3 million during 2005 and \$316,000 during 2006, primarily in respect of AoA. See "Critical Accounting Policies - Other Intangible Assets," above.

FINANCINGS

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

As a result of the application of the above accounting rule, we incurred non-cash charges related to amortization of debt discount attributable to beneficial conversion feature in 2006, 2005 and 2004 in the amount of \$1.5 million, \$1.7 million \$4.1 million, respectively.

ISSUANCES OF RESTRICTED SHARES, OPTIONS AND WARRANTS

During 2004, 2005 and 2006, we issued restricted shares to certain of our employees. These shares were issued as stock bonuses, and are restricted for a period of up to three years from the date of issuance. Relevant accounting rules provide that the aggregate amount of the difference between the purchase price of the restricted shares (in this case, generally zero) and the market price of the shares on the date of grant is taken as a general and administrative expense, amortized over the life of the period of the restriction.

As a result of the application of the above accounting rules, we incurred non-cash charges related to stock-based compensation in 2006, 2005 and 2004 in the amount of \$353,000, \$521,000 and \$884,000, respectively.

As a result of options granted to employees and the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payments," we incurred non-cash charges related to stock-based compensation in the amount of \$154,000 during 2005 and \$141,000 during 2006.

As a result of shares granted to consultants and shares granted as a donation, we incurred non-cash charges related to stock-based compensation in the amount of \$538,000 during 2005 and 7,000 during 2006.

As part of our Securities Purchase Agreement dated September 29, 2005 (see Note 12.d. of the Notes to Consolidated Financial Statements), we issued warrants to purchase up to 375,000 shares of common stock. Because the terms of the warrants referred to above provided that upon exercise of a warrant we could issue only stock that had been registered with the SEC (which occurred in December 2005) and was therefore freely tradable, in accordance with Emerging Issues Task Force No 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the fair value of the warrants was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. The fair value of these warrants was remeasured as at December 31, 2006 using the Black-Scholes pricing model assuming a risk free interest rate of 4.79%, a volatility factor of 81%, dividend yields of 0% and a contractual life of approximately six months. The change in the fair value of the warrants between the date of the grant and December 31, 2006 in the amount of \$39,000 has been recorded as finance expenses

As part of the repricings and exercises of warrants described in Note 12.d. of the Notes to Consolidated Financial Statements, we issued warrants to purchase up to 298,221 shares of common stock. Since the terms of these warrants provided that the warrants were exercisable subject to our obtaining stockholder approval, in accordance with Emerging Issues Task Force No 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the fair value of the warrants was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date until we obtained stockholder approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the stockholder approval) using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$739,000 has been recorded as finance income.

Under the terms of our convertible notes, we have the option in respect of scheduled principal repayments to force conversion of the payment amount at a conversion price based upon the weighted average trading price of our common stock during the 20 trading days prior to the conversion, less a discount of 8%. Because of this discount and the use in a conversion price that is based on the weighted average trading price of our common stock during the 20 trading days prior to the conversion, we incurred a financial expense during 2006 of \$507,000, which represents the shares issued multiplied by the difference between the share price that was used for the conversion and the share price at the day of the conversion.

On April 7, 2006, we and each holder of our convertible notes agreed that we would force immediate conversion of an aggregate of \$6,148,904 principal amount of the convertible notes into 1,098,019 shares of our common stock. The amount converted eliminated our obligation to make the installment payments under the convertible notes on each of March 31, 2008, January 31, 2008, November 30, 2007 and September 30, 2007 (aggregating a total of \$5,833,333). In addition, as a result of the conversion an additional \$315,570 was applied against part of the installment payment due July 31, 2007. After giving effect to the conversion, \$8,434,430 of principal remained outstanding under the convertible notes. As a result of this transaction, we incurred and recorded a financial expense during 2006 of \$4.9 million.

Additionally, in an effort to improve our cash situation and our shareholders' equity, we have periodically induced holders of certain of our warrants to exercise their warrants by lowering the exercise price of the warrants in exchange for immediate exercise of such warrants, and by issuing to such investors new warrants. Under such circumstances, we record a deemed dividend in an amount determined based upon the fair value of the new warrants (using the Black-Scholes pricing model). As and to the extent that we engage in similar warrant repricings and issuances in the future, we would incur similar non-cash charges.

Overview of Operating Performance and Backlog

Overall, our net loss before minority interest earnings, earnings from an affiliated company and tax expenses for 2006 was \$15.7 million on revenues of \$43.1 million, compared to a net loss of \$23.7 million on revenues of \$49.0 million during 2005. As of December 31, 2006, our overall backlog totaled \$41.3 million.

In our Simulation and Training Division, revenues decreased from approximately \$26.8 million in 2005 to \$22.0 million in 2006. As of December 31, 2006, our backlog for our Simulation and Training Division totaled \$11.5 million.

In our Battery and Power Systems Division, revenues decreased from approximately \$9.9 million in 2005 to approximately \$8.6 million in 2006. As of December 31, 2006, our backlog for our Battery and Power Systems Division totaled \$9.2 million.

In our Armor Division, revenues decreased from \$12.3 million during 2005 to \$12.6 million during 2006. As of December 31, 2006, our backlog for our Armor Division totaled \$20.6 million.

Results of Operations

Preliminary Note

SUMMARY

Following is a table summarizing our results of operations for the years ended December 31, 2006, 2005 and 2004, after which we present a narrative discussion and analysis:

	Year Ended December 31,		
	2006	2005	2004
Revenues:			
Simulation and Training Division	\$ 21,951,337	\$ 26,805,772	\$ 21,464,406
Armor Division	12,571,779	12,322,678	17,988,687
Battery and Power Systems Division	8,597,623	9,916,145	10,500,753
	<u>\$ 43,120,739</u>	<u>\$ 49,044,595</u>	<u>\$ 49,953,846</u>
Cost of revenues:			
Simulation and Training Division	\$ 14,196,298	\$ 15,835,735	\$ 11,739,690
Armor Division	12,299,756	11,206,442	15,449,084
Battery and Power Systems Division	5,997,592	7,341,559	6,822,320
	<u>\$ 32,493,646</u>	<u>\$ 34,383,736</u>	<u>\$ 34,011,094</u>
Research and development expenses:			
Simulation and Training Division	\$ 308,738	\$ 209,554	\$ 395,636
Armor Division	20,546	139,514	17,065
Battery and Power Systems Division	1,272,170	951,361	1,318,678
	<u>\$ 1,601,454</u>	<u>\$ 1,300,429</u>	<u>\$ 1,731,379</u>
Sales and marketing expenses:			
Simulation and Training Division	\$ 2,514,981	\$ 2,704,880	\$ 3,185,001
Armor Division	366,923	834,090	565,981
Battery and Power Systems Division	656,604	853,378	1,171,235
All Other	175,814	79,242	-
	<u>\$ 3,714,322</u>	<u>\$ 4,471,590</u>	<u>\$ 4,922,217</u>
General and administrative expenses:			
Simulation and Training Division	\$ 2,562,868	\$ 3,849,881	\$ 2,852,969
Armor Division	1,031,333	2,181,355	1,323,982
Battery and Power Systems Division	994,136	974,704	965,058
All Other	7,104,479	7,856,495	5,514,857
	<u>\$ 11,692,816</u>	<u>\$ 14,862,435</u>	<u>\$ 10,656,866</u>
Other income:			
Simulation and Training Division	\$ 361,560	\$ 338,900	\$ -
Armor Division	-	-	-
Battery and Power Systems Division	-	-	-
All Other	-	-	-
	<u>\$ 361,560</u>	<u>\$ 338,900</u>	<u>\$ -</u>
Financial expense (income):			
Simulation and Training Division	\$ (129,908)	\$ 22,294	\$ 27,842
Armor Division	54,476	(2,463)	13,503
Battery and Power Systems Division	(50,590)	122,236	54,511
All Other	7,645,922	2,563,622	4,133,109
	<u>\$ 7,519,900</u>	<u>\$ 2,705,689</u>	<u>\$ 4,228,965</u>
Tax expenses:			

Simulation and Training Division	\$ 49,383	\$ 63,976	\$ 77,811
Armor Division	-	94,671	134,949
Battery and Power Systems Division	182,776	32,846	320,878
All Other	-	46,179	52,471
	<u>\$ 232,159</u>	<u>\$ 237,672</u>	<u>\$ 586,109</u>
Amortization of intangible assets:			
Simulation and Training Division	\$ 1,049,136	\$ 1,213,261	\$ 1,323,403
Armor Division	295,067	1,348,248	661,914
Battery and Power Systems Division	509,239	509,239	509,239
	<u>\$ 1,853,442</u>	<u>\$ 3,070,748</u>	<u>\$ 2,494,556</u>
Impairment of goodwill and other intangible assets:			
Simulation and Training Division	\$ -	\$ -	\$ 320,279
Armor Division	316,024	12,256,756	-
Battery and Power Systems Division	-	-	-
	<u>\$ 316,024</u>	<u>\$ 12,256,756</u>	<u>\$ 320,279</u>
Gain (loss) from affiliated company:			
Simulation and Training Division	\$ 354,898	\$ (75,000)	\$ -
Armor Division	-	-	-
Battery and Power Systems Division	-	-	-
	<u>\$ 354,898</u>	<u>\$ (75,000)</u>	<u>\$ -</u>
Minority interest in loss (profit) of subsidiaries:			
Simulation and Training Division	\$ -	\$ -	\$ -
Armor Division	17,407	57,149	(44,694)
Battery and Power Systems Division	-	-	-
	<u>\$ 17,407</u>	<u>\$ 57,149</u>	<u>\$ (44,694)</u>
Income (loss) from continuing operations:			
Simulation and Training Division	\$ 2,116,299	\$ 3,170,091	\$ 1,541,775
Armor Division	(1,812,346)	(15,678,786)	(222,485)
Battery and Power Systems Division	(964,304)	(869,178)	(661,166)
All Other	(14,908,808)	(10,545,538)	(9,700,437)
	<u>\$ (15,569,159)</u>	<u>\$ (23,923,411)</u>	<u>\$ (9,042,313)</u>
Loss from discontinued operations:			
Simulation and Training Division	\$ -	\$ -	\$ -
Armor Division	-	-	-
Battery and Power Systems Division	-	(120,000)	-
	<u>\$ -</u>	<u>\$ (120,000)</u>	<u>\$ -</u>
Net income (loss):			
Simulation and Training Division	\$ 2,116,299	\$ 3,170,091	\$ 1,541,775
Armor Division	(1,812,346)	(15,678,786)	(222,485)
Battery and Power Systems Division	(964,304)	(989,178)	(661,166)
All Other	(14,908,808)	(10,545,538)	(9,700,437)
	<u>\$ (15,569,159)</u>	<u>\$ (24,043,411)</u>	<u>\$ (9,042,313)</u>

Fiscal Year 2006 compared to Fiscal Year 2005

Revenues. During 2006, we (through our subsidiaries) recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force training systems and from the provision of maintenance services in connection with such systems.
- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products.
- EFB and Epsilon recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army.

- EFL recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for 2006 totaled \$43.1 million, compared to \$49.0 million in 2005, a decrease of \$5.9 million, or 12.1%. This decrease was primarily attributable to the following factors:

- Decreased revenues from our Simulation and Training Division (\$4.9 million less in 2006 versus 2005).
- Decreased revenues from our Battery and Power Systems Division, particularly Epsilor (\$1.3 million less in 2006 versus 2005).

In 2006, revenues were \$22.0 million for the Simulation and Training Division (compared to \$26.8 million in 2005, a decrease of \$4.9 million, or 18.1%, due primarily to the completion of the common driver training program in 2005, a significant source of revenue in that year.); \$8.6 million for the Battery and Power Systems Division (compared to \$9.9 million in 2005, a decrease of \$1.3 million, or 13.3%, due primarily to decreased sales of Epsilor and CECOM from our EFB subsidiary, offset to some extent by increased WAB revenues from our EFL subsidiary); and \$12.6 million for the Armor Division (compared to \$12.3 million in 2005, an increase of \$249,000, or 2.0%, due primarily to increased revenues from MDT as a result of David orders shipped in the fourth quarter).

Cost of revenues. Cost of revenues totaled \$32.5 million during 2006, compared to \$34.4 million in 2005, a decrease of \$1.9 million, or 5.4%, due primarily to decreased sales in our Battery and Power Systems division and Armor Division and the decrease in margins due to change in the mix of products and customers in 2006 in comparison to 2005. In addition, we incurred substantial expenses in respect of production of a new product in our Armor Division, and we updated our accrual for loss from one of our simulation projects.

Cost of revenues for our three divisions during 2006 were \$14.2 million for the Simulation and Training Division (compared to \$15.8 million in 2005, a decrease of \$1.6 million, or 10.4%; \$6.0 million for the Battery and Power Systems Division (compared to \$7.3 million in 2005, a decrease of \$1.3 million, or 18.3%, due primarily to decreased sales of Epsilor, offset to some extent by increased WAB revenues from our EFL subsidiary); and \$12.3 million for the Armor Division (compared to \$11.2 million in 2005, an increase of \$1.1 million, or 9.8%, due primarily to decreased revenues from MDT and AoA).

Research and development expenses. Research and development expenses for 2006 were \$1.6 million, compared to \$1.3 million during 2005. The small increase in 2006 research and development expenses is due to additional costs in the Battery and Power Systems Division and Simulation and Training Division, slightly offset by a reduction in costs in the Armor Division.

Selling and marketing expenses. Selling and marketing expenses for 2006 were \$3.7 million, compared to \$4.5 million 2005, a decrease of \$757,000, or 16.9%. This decrease was primarily attributable to the overall decrease in revenues and their associated sales and marketing expenses.

General and administrative expenses. General and administrative expenses for 2006 were \$11.7 million, compared to \$14.9 million in 2005, a decrease of \$3.2 million, or 21.3%. This decrease was primarily attributable to the following factors:

- Decreases in certain general and administrative expenses in comparison to 2005, such as auditing, legal expenses and travel expenses, as a result of cost-cutting programs implemented by management, which resulted in a decrease of \$1.3 million over general and administrative expenses in 2005.
- Decrease in general and administrative expenses related to FAAC, primarily payroll, legal and other expenses, which resulted in a decrease of \$493,000 over general and administrative expenses in 2005.
- Decrease in general and administrative expenses related to IES as a result of the consolidation of IES and FAAC operations, which resulted in a decrease of \$398,000 over general and administrative expenses in 2005.
- Decrease in general and administrative expenses related to AoA due to decrease in operations, employees and the relocation of AoA to Alabama, which resulted in a decrease of \$970,000 over general and administrative expenses in 2005.

Financial expenses, net. Financial expenses totaled approximately \$7.5 million in 2006 compared to \$2.7 million in 2005, an increase of \$4.8 million, or 177.9%. The difference was due primarily to interest related to our convertible notes that were issued in September 30, 2005, and financial expenses related to repayment by forced conversion of our convertible notes at an 8% discount to average market price as provided under the terms of the convertible notes, particularly the April 2006 transaction described in “Overview of Results of Operations - Financings,” above.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2006 and, accordingly, no provision for income taxes was recorded. With respect to some of our subsidiaries that operated at a net profit during 2006, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of \$232,000 in tax expenses in 2006, compared to \$238,000 in tax expenses in 2005, mainly due to state taxes.

Amortization of intangible assets. Amortization of intangible assets totaled \$1.9 million in 2006, compared to \$3.1 million in 2005, a decrease of \$1.2 million, or 39.6%, due primarily to a decrease in amortization of intangible assets related to our subsidiary AoA.

Impairment of goodwill and other intangible assets. Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units. We performed the required annual impairment test of goodwill, based on our management’s projections and using expected future discounted operating cash flows. We identified \$316,000 in impairment of goodwill during 2006. In the corresponding period of 2005, we identified in AoA an impairment of goodwill in the amount of \$11.8 million.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with current accounting standards 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. We did not identify any impairment of backlog during 2006. In the corresponding period of 2005, we identified an impairment of backlog previously identified with the AoA acquisition and as a result we recorded an impairment loss in the amount of \$499,000.

Net loss. Due to the factors cited above, net loss from continuing operations decreased from \$23.9 million in 2005 to \$15.6 million in 2006, an improvement of \$8.3 million, or 34.8%.

Net loss attributable to common shareholders. Due to a deemed dividend that was recorded in the amount of \$434,000 in 2006 due to the repricing of existing warrants and the issuance of new warrants (see Note 13.d.3. to the financial statements), net loss attributable to common shareholders was \$16.0 million in 2006, compared to \$24.0 million in 2005, an improvement of \$8.0 million, or 33.4%.

Fiscal Year 2005 compared to Fiscal Year 2004

Revenues. During 2005, we recognized revenues as follows:

- IES and FAAC recognized revenues from the sale of interactive use-of-force and driver operator training systems and from the provision of maintenance services in connection with such systems;
- MDT, MDT Armor and AoA recognized revenues from payments under vehicle armoring contracts, for service and repair of armored vehicles, and on sale of armoring products;
- EFB and Epsilor recognized revenues from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army; and

- EFL recognized revenues from the sale of lifejacket lights and from subcontracting fees received in connection with Phase IV of the United States Department of Transportation (DOT) electric bus program.

Revenues for the year ended December 31, 2005 totaled \$49.0 million, compared to \$50.0 million for 2004, a decrease of \$949,000, or 2%. This decrease was primarily attributable to the decreased revenues of our Armor Division, specifically decreased revenues of MDT Armor (\$5.1 million during 2005 compared to \$13.4 million in 2004).

These decreased revenues were offset to some extent by increased revenues from our Simulation and Training Division (\$26.8 million in 2005 compared to \$21.5 million in 2004), due primarily to the increased revenues of FAAC.

In 2005, revenues were as follows:

- \$26.8 million for the Simulation and Training Division, compared to \$21.5 million in 2004, an increase of \$5.3 million, or 25%, due primarily to the increased revenues of FAAC (approximately \$4.5 million).
- \$12.3 million for the Armor Division, compared to \$18.0 million in 2004, a decrease of \$5.7 million, or 32%, due primarily to the decreased revenues from MDT Armor (approximately \$8.3 million) as a result of a slowdown in armoring orders related to the Iraq War. This decrease was partially offset by higher revenues recorded by us in 2005 from AoA in comparison to 2004, due to the fact that AoA's revenues were included for all of 2005 but only for the last five months of 2004. On a pro forma basis, AoA's revenues decreased in 2005 versus 2004, due to decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan, and, following Hurricane Katrina, the fact that substantial funds earmarked for defense were delayed to provide funds for hurricane relief.
- \$9.9 million for the Battery and Power Systems Division, compared to \$10.5 million in 2004, a decrease of \$585,000, or 6%, due primarily to decreased sales of lithium batteries and chargers by our Epsilon subsidiary as a result of reduced equipment purchases by one of its customers, offset to some extent by increased revenues from our Zinc-Air military batteries.

Cost of revenues. Cost of revenues totaled \$34.4 million during 2005, compared to \$34.0 million in 2004, an increase of \$373,000, or 1%, due primarily to increased cost of goods sold related to the write off of inventory in the Armor Division in the amount of \$1.1 million in 2005.

Direct expenses for our three divisions during 2005 were \$22.0 million for the Simulation and Training Division, compared to \$17.9 million in 2004, an increase of \$4.1 million, or 23%, due primarily to the addition of expenses associated with increased sales of driver training systems through FAAC (approximately \$4.5 million), offset to some extent by decreased expenses associated with the sales of use-of-force training systems; \$14.0 million for the Armor Division, compared to \$16.4 million in 2004, a decrease of \$2.5 million, or 15%, due primarily to decreased revenues of MDT Armor (\$5.1 million during 2005 compared to \$13.4 million in 2004), offset to some extent by increased expenses associated with AoA, including inventory write-off; and \$9.8 million for the Battery and Power Systems Division, compared to \$10.0 million in 2004, a decrease of \$217,000, or 2%, due primarily to decreased revenues from Epsilon.

Research and development expenses. Research and development expenses for 2005 were \$1.3 million, compared to \$1.7 million in 2004, a decrease of \$431,000, or 25%. This decrease was primarily attributable to allocating research and development expenses to the cost of revenues due to research and development contracts in the Battery and Power Systems Division and due to higher capitalization of software in the amount of \$286,000 in 2005 compared to 2004.

Sales and marketing expenses. Sales and marketing expenses for 2005 were \$4.5 million, compared to \$4.9 million in 2004, a decrease of \$451,000, or 9%. This decrease was primarily attributable to the decrease in sales commissions in the Battery and Power Systems Division.

General and administrative expenses. General and administrative expenses for 2005 were \$14.9 million, compared to \$10.7 million in 2004, an increase of \$4.2 million, or 39%. This increase was primarily attributable to the following factors:

- The inclusion of the general and administrative expenses of AoA in our results for all of 2005 but only five months of 2004 (\$836,000);
- Increases in general and administrative expenses in our FAAC subsidiary due to legal expenses, employee relocation, accounting, incentive pay accruals, and similar expenses (\$809,000);
- Increase in other corporate general and administrative expenses such as auditing, legal and travel expenses (\$800,000); and
- Increase in costs related to abandoned acquisition activities (\$1.1 million).

Financial expenses, net. Financial expense, net of interest income and exchange differentials, totaled approximately \$2.7 million in 2005, compared to \$4.2 million in 2004, a decrease of \$1.5 million, or 36%. This decrease was due primarily to the decreased amortization of compensation related to warrants issued to the holders of convertible securities and related beneficial conversion feature.

Income taxes. We and certain of our subsidiaries incurred net operating losses during 2005 and, accordingly, we were not required to make any provision for income taxes. With respect to some of our subsidiaries that operated at a net profit during 2005, we were able to offset federal taxes against our net operating loss carry forwards. We recorded a total of \$238,000 in tax expenses in 2005, with respect to certain of our subsidiaries that operated at a net profit during 2005 and we are not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes. We recorded a total of \$586,000 in tax expenses in 2004, with respect to certain of our subsidiaries that operated at a net profit during 2004 and we were not able to offset their taxes against our net operating loss carry forwards and with respect to state taxes.

Amortization of intangible assets. Amortization of intangible assets totaled \$3.1 million in 2005, compared to \$2.5 million in 2004, an increase of \$576,000, or 23%, due primarily to amortization of intangible assets related to our AoA subsidiary that we acquired in August 2004.

Impairment of goodwill and other intangibles assets. Current accounting standards require us to test goodwill for impairment at least annually, and between annual tests in certain circumstances; when we determine goodwill is impaired, it must be written down, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units.

During 2005, we performed an impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows, as a response to several factors, including without limitation the reduced sales in AoA (a component of our Armor Division), the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA us, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular - specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), and the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, substantial funds earmarked for defense were delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, we identified in AoA an impairment of goodwill in the amount of \$11.8 million.

Our and our subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with current accounting standards 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. As of December 31, 2004, we identified an impairment of the technology previously purchased from Bristlecone and, as a result, we recorded an impairment loss in the amount of \$320,000. As of December 31, 2005, we identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and, as a result, we recorded an impairment loss in the amount of \$499,000.

Loss from continuing operations. Due to the factors cited above, we reported a loss from continuing operations of \$23.9 million in 2005, compared to \$9.0 million in 2004, an increase of \$14.9 million, or 165%.

Loss from discontinued operations. Net loss from discontinued operations for 2005 was \$120,000 compared to \$0 in 2004. This is because during the second quarter of 2005 we took an accrual of \$200,000 for a litigation contingency related to the discontinued operations; in March 2006, this litigation was settled for \$120,000.

Net loss before deemed dividend of common stock to certain stockholders. Due to the factors cited above, we reported a net loss of \$24.0 million in 2005, compared to a net loss of \$9.0 million in 2004, an increase of \$15.0 million, or 166%.

Net loss after deemed dividend of common stock to certain stockholders. In 2004 we had a deemed dividend of \$3.3 million (see Notes 13.d.3. and 13.d.4. to the financial statements) that we did not have in 2005. Accordingly, net loss after deemed dividend of common stock to certain stockholders was \$24.0 million in 2005, compared to \$12.4 million in 2004, an increase of \$11.7 million, or 94%.

Liquidity and Capital Resources

As of December 31, 2006, we had \$2.4 million in cash, \$649,000 in restricted collateral securities and restricted held-to-maturity securities due within one year, \$1.4 million in an escrow receivable and \$41,000 in available-for-sale marketable securities, as compared to at December 31, 2005, when we had \$6.2 million in cash, \$3.9 million in restricted collateral securities and restricted held-to-maturity securities due within one year, \$779,000 in long-term restricted deposits, and \$36,000 in available-for-sale marketable securities. We also had \$994,000 available in unused bank lines of credit.

We used available funds in 2006 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets by \$1.4 million during the year ended December 31, 2006, primarily in the Battery and Power Systems Division and in the Simulation and Training Division. Our net fixed assets amounted to \$3.7 million as at year end.

Net cash used in operating activities for 2006 and 2005 was \$3.6 million and \$11.1 million, respectively, a decrease of \$7.5 million. This decrease was primarily the result of a decrease in trade receivables in 2005 offset by a decrease in trade payables in 2005 in comparison to 2006.

Net cash used in investing activities for 2006 and 2005 was \$487,000 and \$11.8 million, respectively, a decrease of \$11.3 million. This increase was primarily the result of warrant exercises during 2006, the proceeds of which were deposited in restricted accounts for the payment of our convertible debentures due in September 2006, resulting in an increase in restricted securities and deposits.

Net cash provided by (used in) financing activities for 2006 and 2005 was \$452,000 and \$22.2 million, respectively, a decrease of \$21.7 million. This decrease was primarily the result of the issuance of debentures in 2005, partially offset by warrant exercises in February, March and April of 2006 (see Note 12.d. to the financial statements).

As of December 31, 2006, we had (based on the contractual amount of the debt and not on the accounting valuation of the debt, not taking into consideration trade payables, other accounts payables and accrued severance pay) approximately \$2.6 million in bank and certificated debt outstanding, all of which was convertible debt, and approximately \$3.5 million in short-term debt.

Our debt agreements with the holders of our convertible notes contain customary affirmative and negative operations covenants that limit the discretion of our management with respect to certain business matters and place restrictions on us, including obligations on our part to preserve and maintain our assets and restrictions on our ability to incur or guarantee debt, to merge with or sell our assets to another company, and to make significant capital expenditures without the consent of the debenture holders. The schedule of payments to the holders of our convertible notes, as amended, calls for the notes to be paid off by July 31, 2007.

Based on our internal forecasts, which are 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, lines of credit and anticipated additions to paid-in capital should be sufficient to satisfy our current estimated cash requirements through the remainder of the year. This belief is based on certain earnout and other assumptions that our management and our subsidiaries managers believe to be reasonable, some of which are subject to the risk factors detailed under “Item 1A. Risk Factors” above, including without limitation (i) that the severance and retirement benefits that we owe to certain of our senior executives will not have to be paid ahead of their anticipated schedule, and (ii) that no other earnout payments to the former shareholder of AoA will be required in excess of the funds being held by him in escrow to secure such earnout obligations. In this connection, we note that from time to time our working capital needs are partially dependent on our subsidiaries’ lines of credit. In the event that we are unable to continue to make use of our subsidiaries’ lines of credit for working capital on economically feasible terms, our business, operating results and financial condition could be adversely affected.

Effective Corporate Tax Rate

We and certain of our subsidiaries incurred net operating losses during the years ended December 31, 2006 and 2005, and accordingly no provision for income taxes was required. With respect to some of our U.S. subsidiaries that operated at a net profit during 2006, we were able to offset federal taxes against our net operating loss carryforward, which amounted to approximately \$34.2 million as of December 31, 2006. These subsidiaries are, however, subject to state taxes that cannot be offset against our net operating loss carryforward. With respect to certain of our Israeli subsidiaries that operated at a net profit during 2006, we were unable to offset their taxes against our net operating loss carryforward, and we are therefore exposed to Israeli taxes, at a rate of up to 31% in 2006 (less, in the case of companies that have “approved enterprise” status as discussed in Note 14.b. to the Notes to Financial Statements).

As of December 31, 2006, we had a U.S. net operating loss carryforward of approximately \$35.6 million that is available to offset future taxable income under certain circumstances, expiring primarily from 2009 through 2026, and foreign net operating and capital loss carryforwards of approximately \$90.0 million, which are available indefinitely to offset future taxable income under certain circumstances.

Contractual Obligations

The following table lists our contractual obligations and commitments as of December 31, 2006, not including trade payables and other accounts payable:

Contractual Obligations	Payment Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt	\$ -	\$ -	\$ -	\$ -	\$ -
Short-term debt*	\$ 6,079,637	\$ 6,079,637	\$ -	\$ -	\$ -
Promissory note due to purchase of subsidiaries	\$ 454,350	\$ 302,900	\$ 151,450	\$ -	\$ -
Operating lease obligations**	\$ 793,422	\$ 621,678	\$ 166,282	\$ 5,462	\$ -
Capital lease obligations	\$ 269,756	\$ 79,623	\$ 138,811	\$ 51,322	\$ -
Severance obligations***	\$ 4,039,049	\$ -	\$ 4,039,049	\$ -	\$ -

* Includes convertible securities in the gross amount of \$2,583,629. Also includes \$3,496,008 in short-term bank debt.

** Includes operating lease obligations related to rent.

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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The financial statements have been restated to give effect to a one-for-fourteen reverse stock split effected on June 21, 2006.

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

Effective as of June 20, 2006, BDO Seidman, LLP replaced Kost, Forer, Gabbay and Kasierer, a member of Ernst & Young Global, as our independent registered public accounting firm. This change was reported in a Current Report on Form 8-K filed on June 26, 2006. There have been no disagreements with accountants on any matter of accounting principles or financial disclosure required to be reported under this Item.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2006, 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, 2006, our principal executive officer and principal financial officer were able to conclude that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

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

Management's Report on Internal Control Over Financial Reporting

Our management, including our principal executive and financial officers, is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Our management has evaluated the effectiveness of our internal controls as of the end of the period covered by this Annual Report on Form 10-K for the year ended December 31, 2006. 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, 2006.

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

Changes in Internal Controls Over Financial Reporting

In the last fiscal quarter of 2006, we confirmed we had completed the enhancement of our internal controls relating to the monitoring, review and approval of revenue recognition calculations at our FAAC subsidiary. Specifically, we implemented controls to ensure that revenue recognition calculations at FAAC are reviewed by appropriate accounting personnel at FAAC to determine that revenue is recognized in accordance with company policy and generally accepted accounting principles. Management, with the oversight of the Audit Committee, has addressed the material weakness related to the monitoring, review and approval of revenue recognition calculations at FAAC identified in previous periods and has concluded that it has been successfully remediated.

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

ITEM 9B. OTHER INFORMATION

None.

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, 2007 were as follows:

Name	Age	Position
Robert S. Ehrlich	68	Chairman of the Board and Chief Executive Officer
Steven Esses	43	President, Chief Operating Officer and Director
Thomas J. Paup	58	Vice President - Finance and Chief Financial Officer
Dr. Jay M. Eastman	58	Director
Jack E. Rosenfeld	68	Director
Lawrence M. Miller	60	Director
Edward J. Borey	56	Director
Seymour Jones	75	Director

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 Mr. Esses are designated Class I directors and have been elected for a term expiring in 2009 and until their successors are elected and qualified; Messrs. Rosenfeld, Miller and Jones are designated Class II directors elected for a term expiring in 2008 and until their successors are elected and qualified; and Messrs. Ehrlich and Borey are designated Class III directors elected for a term that expires in 2007 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 President and Chief Executive Officer since October 2002. In December 2005, Mr. Ehrlich ceased to hold the title of President. From May 1991 until January 1993, Mr. Ehrlich was our Vice Chairman of the Board, and from May 1991 until October 2002, he was our Chief Financial Officer. Mr. Ehrlich was a director of Eldat, Ltd., an Israeli manufacturer of electronic shelf labels, from June 1999 to July 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. PSCX filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in November 2002. Mr. Ehrlich received a B.S. and J.D. from Columbia University in New York, New York.

Steven Esses has been a director since July 2002, our Executive Vice President since January 2003, our Chief Operating Officer since February 2003 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. From 1995 to 2000, Mr. Esses founded Dunkin’ Donuts in Israel and held the position of Managing Director and CEO. Prior thereto, he was 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.

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.

Dr. Jay M. Eastman has been one of our directors since October 1993. Since November 1991, Dr. Eastman has served as President and Chief Executive Officer of Lucid, Inc., which is developing laser technology applications for medical diagnosis and treatment. 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 January 1983, Dr. Eastman was Director of the University of Rochester's Laboratory for Laser Energetics, where he was a member of the staff from September 1975 to 1981. Dr. Eastman holds a B.S. and a Ph.D. in Optics from the University of Rochester in New York.

Jack E. Rosenfeld has been one of our directors since October 1993. Mr. Rosenfeld was President and Chief Executive Officer of Potpourri Group Inc. ("Potpourri"), a specialty catalog direct marketer, from April 1998 until June 2003; from June 2003 until February 2005, Mr. Rosenfeld served as Chairman of Potpourri's Board of Directors and as its CEO, and since February 2005, Mr. Rosenfeld has been Executive Chairman of the Potpourri Board of Directors. Mr. Rosenfeld was President and Chief Executive Officer of Hanover Direct, Inc., formerly Horn & Hardart Co., which operates a direct mail marketing business, from September 1990 until December 1995, and had been President and Chief Executive Officer of its direct marketing subsidiary, from May 1988 until September 1990. Mr. Rosenfeld holds a B.A. from Cornell University in Ithaca, New York and an LL.B. from Harvard University in Cambridge, Massachusetts.

Lawrence M. Miller was elected to the board of directors in November 1996. Mr. Miller has been a senior partner in the Washington D.C. law firm of Schwartz, Woods and Miller since 1990. He served from August 1993 through May 1996 as a member of the board of directors of The Phoenix Resource Companies, Inc., a publicly traded energy exploration and production company, and as a member of the Audit and Compensation Committee of that board. That company was merged into Apache Corporation in May 1996. Mr. Miller holds a B.A. from Dickinson College in Carlisle, Pennsylvania and a J.D. with honors from George Washington University in Washington, D.C. He is a member of the District of Columbia bar.

Edward J. Borey has served as a director 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 (NasdaqNM: WGRD). From December 2000 to September 2003, Mr. Borey served as President, Chief Executive Officer and a director of PSCX. PSCX filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in November 2002. 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.

Seymour Jones has served as a director since July 2005. Mr. Jones is a clinical professor of accounting at New York University Stern School of Business. Professor Jones teaches courses in auditing, tax and legal aspects of entrepreneurship. He is also the Associate Director of Ross Institute of Accounting Research at Stern School of Business. Professor Jones has been with NYU Stern for ten years. His primary research areas include audit committees, auditing, entrepreneurship, financial reporting, and fraud. Professor Jones has been principal author of numerous books including *Conflict of Interest*, *The Cooper & Lybrand Guide to Growing Your Business*, *The Emerging Business* and *The Bankers Guide to Audit Reports and Financial Statements*. Before joining NYU Stern, Professor Jones was senior partner at Coopers & Lybrand and S.D. Leidesdorf & Co. 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.

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. Miller and Rosenfeld. We have determined that Prof. Jones qualifies as an “audit committee financial expert” under applicable SEC and Nasdaq regulations. Prof. Jones, as well as all the other members of the Audit Committee, is “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. Rosenfeld and Borey, 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), Miller, Borey and Esses.

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. Rosenfeld (Chair), Mr. Miller and Dr. Eastman, 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>.

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 paid \$2,500 (plus expenses) for each board of directors meeting attended, \$2,000 (plus expenses) for each meeting of the audit committee of the board of directors attended, and \$1,000 (plus expenses) for each meeting of all other committees of the board of directors attended. In addition, we have adopted a Non-Employee Director Stock Option Plan pursuant to which non-employee directors receive an initial grant of options to purchase 2,857 shares of our common stock upon the effective date of such plan or upon the date of his or her election as a director. Thereafter, non-employee directors will receive options to purchase 1,786 shares of our common stock for each year of service on the board. All such options are granted at fair market value and vest ratably over three years from the date of the grant. During 2005, our directors agreed to an interim reduction in their fees of 25% as part of our overall cost-cutting strategy.

The following table shows the compensation earned or received by each of our non-officer directors for the year ended December 31, 2006:

DIRECTOR COMPENSATION

Name	Fees Earned or Paid in Cash (\$)	Option Awards (1) (\$)	Total (\$)
Dr. Jay M. Eastman	\$ 27,375	\$ 30,157 ⁽²⁾	\$ 57,532
Jack E. Rosenfeld	\$ 42,000	\$ 30,157 ⁽³⁾	\$ 72,157
Lawrence M. Miller	\$ 40,500	\$ 30,157 ⁽⁴⁾	\$ 70,657
Edward J. Borey	\$ 33,375	\$ 20,074 ⁽⁵⁾	\$ 53,449
Seymour Jones	\$ 25,125	\$ 1,705 ⁽⁶⁾	\$ 26,830

(1) This column reflects the compensation cost for the year ended December 31, 2006 of each director's options, calculated in accordance with SFAS 123R and using a Black-Scholes valuation model. See Note 2.r. of the Notes to Consolidated Financial Statements for a discussion of the assumptions we made in determining the grant date fair value and compensation costs of our equity awards.

(2) As of December 31, 2006, Dr. Eastman held options to purchase an aggregate of 13,570 shares of our common stock, 8,570 shares of which were vested as of that same date.

- (3) As of December 31, 2006, Mr. Rosenfeld held options to purchase an aggregate of 13,570 shares of our common stock, 8,570 shares of which were vested as of that same date.
- (4) As of December 31, 2006, Mr. Miller held options to purchase an aggregate of 13,570 shares of our common stock, 8,570 shares of which were vested as of that same date.
- (5) As of December 31, 2006, Mr. Borey held options to purchase an aggregate of 10,000 shares of our common stock, 5,000 shares of which were vested as of that same date.
- (6) As of December 31, 2006, Prof. Jones held options to purchase an aggregate of 2,500 shares of our common stock, none of which was vested as of that same date.

Significant Employees

Our significant employees as of February 28, 2007, and their ages as of December 31, 2006, are as follows:

Name	Age	Position
Jonathan Whartman	52	Senior Vice President
Yaakov Har-Oz	49	Senior Vice President, General Counsel and Secretary
William Graham	47	Vice President of Government Affairs
Norman Johnson	54	Controller
Dean Krutty	41	President, Simulation Division
Yosef Bar	64	General Manager, MDT Protective Industries
Ronen Badichi	41	General Manager, Epsilon Electronics Industries, Ltd.
Graydon Hansen	48	President, Electric Fuel Battery Corporation

Jonathan Whartman has been Senior Vice President since December 2000, and Vice President of Marketing from 1994 to December 2000. From 1991 until 1994, Mr. Whartman was our Director of Special Projects. Mr. Whartman was also Director of Marketing of Amtec from its inception in 1989 through the merger of Amtec into Arotech in 1991. Before joining Amtec, Mr. Whartman was Manager of Program Management at Luz, Program Manager for desktop publishing at ITT Qume in San Jose, California from 1986 to 1987, and Marketing Director at Kidron Digital Systems, an Israeli computer developer, from 1982 to 1986. Mr. Whartman holds a B.A. in Economics and an M.B.A. from the Hebrew University, Jerusalem, Israel.

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, Hachohen & 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 Advocates.

William Graham joined us as Vice President of Government Affairs in January 2005, after twenty years of military service highlighted by multiple commands and six years of Pentagon experience. During this time, Mr. Graham interacted continuously with Senators and their staffs to develop and execute the strategy for presenting the \$300+ billion defense budget. After retiring from the Army as a Colonel in 2001, Mr. Graham joined Washington Operations for Time Domain Corporation (TDC) as a Director to help the company secure Pentagon contracts and congressional support for those programs. Mr. Graham completed a B.S. in General Engineering at the U.S. Military Academy (West Point) in 1980, earned his masters from Central Michigan University in 1991 and was graduated from the U.S. Army War College in 1999.

Norman 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.

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 FAC 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 simulation and training industry. Mr. Krutty holds a B.S. in electrical engineering from the Michigan State University.

Yosef Bar established MDT Protective Industries in 1989 as one of the first bulletproofing companies in Israel. Under the direction of Mr. Bar, MDT moved from its initial emphasis on vandalism protection to bulletproofing not just windshields but the entire vehicle, as a result of which MDT became Israel's leader in the state-of-the art lightweight armoring of vehicles. Mr. Bar served in the Israel Defense Forces, reaching the rank of Lieutenant Colonel of the paratroop regiment with over 1,000 jumps to his credit. He also participated in several anti-terrorism courses.

Ronen Badichi became the General Manager of Epsilor Electronic Industries in May 2005. Prior to joining Epsilor, 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.

Graydon Hansen has served as President of EFB since January 2005. Prior thereto, Mr. Hansen was Senior Vice President of Engineering with Elpac Electronics, Inc. From March 2002 until February 2004, Mr. Hansen was Vice President of Engineering at Trojan Battery Corporation, where his management responsibilities included commercial product development and design activity, plus leadership of the Quality and Production Engineering groups in all of Trojan's manufacturing facilities. Previously, Mr. Hansen worked at Lockheed Missiles and Space Company. Mr. Hansen holds a B.Sc. in electric engineering from the University of California at Berkeley, and is a Registered Professional Engineer and a Certified Quality Engineer.

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 2006. We are not aware of any instances during 2006, not previously disclosed by us, where such “reporting persons” failed to file the required reports on or before the specified dates.

ITEM 11. EXECUTIVE COMPENSATION

Compensation Committee Report

Under the rules of the SEC, this Compensation Committee Report is not deemed to be incorporated by reference by any general statement incorporating this Annual Report by reference into any filings with the SEC.

The Compensation Committee has reviewed and discussed the following Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with management and, based on such review and discussions, the Compensation Committee recommended to the Board of Directors that the following Compensation Discussion and Analysis be included in this Annual Report on Form 10-K.

Submitted by the Compensation Committee

Dr. Jay M. Eastman, Chairman
Jack E. Rosenfeld
Edward J. Borey

Compensation Discussion and Analysis

Introduction

In this section we present the principles underlying our executive officer compensation decisions and the most important factors that we believe are relevant to an analysis of these decisions. Our goal here is to provide qualitative information regarding the manner and context in which compensation is awarded to and earned by our executive officers and to place in perspective the numerical and other quantitative data presented in the tables and other information that follow this section.

Pursuant to applicable SEC regulations, the information we present in this section relates to the chief executive officer, the chief financial officer, and the three additional most highly compensated “executive officers” (as this term is defined in the regulations promulgated under the Securities Exchange Act of 1934, as amended), as well as up to two additional persons meeting the above criteria but who were not employed by us at the end of the last fiscal year. We believe that in 2006 four individuals met these criteria, as follows (we refer to these individuals throughout this Compensation Discussion and Analysis as our “executive officers”):

- Robert S. Ehrlich, our Chairman and Chief Executive Officer;

- Steven Esses, our President and Chief Operating Officer;
- Thomas J. Paup, our Vice President - Finance and Chief Financial Officer; and
- Avihai Shen, our former Vice President - Finance and Chief Financial Officer, who ceased to act as our Chief Financial Officer in February 2006, and whose employment with us terminated on March 31, 2006.

We have designed the compensation of our executive officers in order to attract, as needed, individuals with the skills necessary for us to achieve our business plan, to reward those individuals fairly over time, and to retain those individuals who perform at or above our expectations.

Our executive officers' annual cash and stock compensation consists of several components, as follows:

- cash salary;
- bonus, some of which is paid in cash in the year in which it is earned and some of which is accrued in the year in which it is earned but is paid in cash in a subsequent year;
- stock options; and
- grants of restricted stock, where (i) the stock vests over a period of time or pursuant to the attainment of set goals, (ii) sale of such stock is prohibited for a period of time, and (iii) with respect to certain grants of restricted stock, unvested stock is forfeited to us should the executive officer's employment be terminated under certain circumstances.

The Compensation Committee reviews the compensation, both cash and stock, of our executive officers on an annual basis, while taking into account as well changes in compensation during previous years.

Some of these components, such as salary, are generally fixed and do not vary based on our financial and other performance; some components, such as bonus, are in whole or in part dependent upon the achievement of certain goals jointly agreed upon by our management and the Compensation Committee; and some components, such as stock options and restricted stock, have a value that is dependent upon our stock price at the time of award and going forward.

We compensate our executive officers in these different ways in order to achieve different goals. Cash compensation, for example, provides our executive officers with a guaranteed minimum base salary. We fix the base salary of each of our executive officers at a level that we believe enables us to hire and retain individuals in a competitive environment and rewards satisfactory individual performance and a satisfactory level of contribution to our overall business goals. We also take into account the base salaries paid by similarly situated companies and the base salaries of other private and public companies with which we believe we compete for talent. To this end, we utilize the services of an employee benefits administration and compensation consulting firm retained by the Compensation Committee, and our Compensation Committee consults with this firm periodically, and annually when we review executive officer compensation.

Incentive bonus compensation is generally linked to the achievement of short-term operational, strategic or financial goals, and is intended to reward our executive officers for their performance in reaching goals that are agreed in advance between our management and the Compensation Committee. We designed the cash incentive bonuses for each of our executive officers to focus the executive officer on achieving key objectives within a yearly time horizon, as described in more detail below.

Stock options and grants of restricted stock are intended to link our executive officers' longer-term compensation with the performance of our stock, which is an issue of vital importance to our stockholders. This encourages our executive officers to remain with us, to act in ways intended to maximize stockholder value, and to penalize them if our stock fails to perform to expectations. These options and grants are intended to produce significant value for each executive officer if our stock performance is outstanding and if the executive officer remains with us.

We view the three components of our executive officer compensation as related but distinct. Although our Compensation Committee does review total compensation, we do not believe that compensation derived from one component of compensation should negate or reduce compensation from other components. We determine the appropriate level for each compensation component based in part, but not exclusively, on our view of internal equity and consistency, individual performance and other information we deem relevant, such as the data we receive from the consulting firm referred to above. Except as described below, our Compensation Committee has not adopted any formal or informal policies or guidelines for allocating compensation between long-term and currently paid out compensation, between cash and non-cash compensation, or among different forms of compensation. This is due to the small size of our executive officer team and the need to tailor each executive officer's award to attract and retain that executive officer.

In addition, we provide our executive officers with benefits that are generally available to our salaried employees. With respect to those of our executive officers who live in Israel (all of our executive officers except for Mr. Paup), we also provide other benefits that are either legally required to be paid by Israeli law or that are otherwise customarily provided in Israel, primarily consisting of:

- accruals (but not cash payments) in respect of pension plans, which consist of a savings plan, life insurance and statutory severance pay benefits, and a continuing education fund;
- accruals (but not cash payments) in respect of contractual termination compensation in excess of the Israeli statutory minimum;
- the use of an automobile and cash reimbursement for certain Israeli taxes on the use of that automobile that are paid by our Israeli executive officers and reimbursed by us in accordance with Israeli tax regulations;
- annual statutory holiday pay; and

- redemption of all unused vacation days and up to a maximum of 30 unused sick days.

Our Compensation Committee performs an annual review of our executive officers' cash compensation and share and option holdings to determine whether they provide adequate compensation for the services they perform, as well as adequate incentives and motivation to our executive officers and whether they adequately compensate our executive officers relative to comparable officers in other companies. Our Compensation Committee's most recent review occurred in November 2006, and utilized data and assessments from The Burke Group, Inc., a well-known consulting firm specializing in executive officer compensation. This review is described in more detail below. We also use "tally sheets" that provide a summary of the compensation history of our Chief Executive Officer and those members of senior management reporting to the Chief Executive Officer. These tally sheets include a historical summary of base salary, annual bonus and long-term equity awards. They also provide a review of wealth and retirement accumulation as a result of employment with us, which becomes one factor that we take into account in determining future equity-based compensation.

Compensation Committee meetings typically have included, for all or a portion of some of the meetings, a representative of The Burke Group, as well as preliminary discussion with our Chairman and Chief Executive Officer prior to our Compensation Committee deliberating without any members of management present. For compensation decisions, including decisions regarding the grant of equity compensation relating to executive officers (other than our Chairman and Chief Executive Officer), the Compensation Committee typically considers the recommendations of our Chairman and Chief Executive Officer.

We account for the equity compensation expense for our employees under the rules of SFAS 123R, which requires us to estimate and record an expense for each award of equity compensation over the service period of the award. Accounting rules also require us to record cash compensation as an expense at the time the obligation is accrued. Until we achieve sustained profitability, the availability to us of a tax deduction for compensation expense is not material to our financial position. We structure cash incentive bonus compensation so that it is taxable to our employees at the time it becomes available to them. It is not anticipated that any executive officer's annual cash compensation will exceed \$1 million, and we have accordingly not made any plans to qualify for any compensation deductions under Section 162(m) of the Internal Revenue Code.

Benchmarking of Base Compensation and Equity Holdings

At its November 2006 meeting, our Compensation Committee determined that our respective executive officers' salaries, cash incentive bonuses and equity holdings were at or near the median of executive officers with similar roles at public companies having comparable revenues and that no material changes should be made to the cash compensation levels of our executive officers until our annual executive officer performance reviews are conducted early in the first quarter of 2008, other than the grant of additional restricted stock (25% of which was made contingent on renunciation of outstanding stock options and the remainder of which vested over three years, subject to performance criteria) made in December 2006 and reflected in the "Grants of Plan-Based Awards" table below. This median was derived based on a report we obtained from The Burke Group. The report compared our executive officer compensation with the results of two surveys, involving 43 companies in the aerospace industry with revenues of between \$25 million and \$75 million, one from Mercer Human Resource Consulting and one from Watson Wyatt Worldwide. Our Compensation Committee realizes that benchmarking our compensation against the compensation earned at comparable companies may not always be appropriate, but believes that engaging in a comparative analysis of our compensation practices is useful. In instances where an executive officer is uniquely key to our success, the Compensation Committee may provide compensation above the median referred to above. The Committee's choice not to recommend to the Board of Directors immediate material changes to the compensation levels following its review of The Burke Group's report reflects our consideration of stockholders' interests in paying what is necessary, but not significantly more than necessary, to achieve our corporate goals while conserving cash and equity as much as is practicable. We believe that our compensation levels are generally sufficient to retain our existing executive officers and to hire new executive officers when and as required.

Equity Compensation

No option grants were made in 2006. At the November 2006 meeting of the Compensation Committee, the Compensation Committee, in consultation with The Burke Group, analyzed the current share and options holdings, and the pricing of stock options, of our executive officers and others, and found that the level of equity stake of our executive officers was lower than the norm for companies of similar size and experience as a public company, and concluded that this level was insufficient to provide our executive officers with the desired level of value for each executive officer if our stock performance is outstanding and if the executive officer remains with us. Accordingly, based on the number of options and restricted shares held by our executive officers and the prices of these options, the Compensation Committee, in December 2006, made the grants of restricted stock reflected in the "Grants of Plan-Based Awards" table below.

We do not have any program, plan or obligation that requires us to grant equity compensation to any executive officer on specified dates. The authority to make equity grants to executive officers rests with our Compensation Committee, although, as noted above, the Compensation Committee does consider the recommendations of its Chairman and Chief Executive Officer in setting the compensation of our other executive officers.

Cash Incentive Bonuses

Yearly cash incentive bonuses for our executive officers are established as part of their respective individual employment agreements. Each of these employment agreements provides that the executive officer will receive a cash incentive bonus determined in the discretion of our Board of Directors, with a target bonus amount specified for that executive officer based on individualized objective and subjective criteria, pursuant to a specific formula. In 2006, pursuant to the terms of his then-current employment agreement, Mr. Ehrlich was also entitled to a guaranteed minimum bonus equal to 35% of his base salary. This guaranteed minimum bonus was eliminated in Mr. Ehrlich's current employment agreement (see "Employment Contracts - Robert S. Ehrlich," below). These bonus criteria are established by the Compensation Committee on an annual basis, and include specific objectives relating to the achievement of business and/or financial milestones. The target cash incentive bonus amount for each of our executive officers is as follows:

Name of Executive Officer	Title	Minimum Bonus	Maximum Bonus
Robert S. Ehrlich	Chairman and Chief Executive Officer	35% of annual base salary	75% of annual base salary
Steven Esses	President and Chief Operating Officer	20% of annual base salary	75% of annual base salary
Thomas J. Paup	Vice President - Finance and Chief Financial Officer	None	50% of annual base salary
Avihai Shen	Former Vice President - Finance and Chief Financial Officer	None	None

For 2006, the Compensation Committee choose financial targets for determining eligibility for the above-referenced cash incentive bonuses that are determined on the achievement of set budgetary forecast targets for EBITDA, which is determined by taking net profit and adding back in interest expense (income), net (after deduction of minority interest), depreciation of fixed assets, taxes (after deduction of minority interest), and amortization of inventory adjustments and of intangible assets, capitalized software costs and technology impairment, as well as of certain specific non-financial objectives to be accomplished. The Compensation Committee determined that we did not achieve the financial performance criteria established by the Compensation Committee for the year ended December 31, 2006, and accordingly no cash incentive bonuses were paid in respect of the year ended December 31, 2006, although the Compensation Committee did determine to pay certain discretionary bonuses, noted in the Summary Compensation Table below, based on the achievement of certain of the non-financial objectives in respect of the achievement of certain of the non-financial objectives. Financial targets for 2007 were set in accordance with our 2007 budget forecast, and targets for determining eligibility for cash incentive bonuses will again be determined 50% on the achievement of set budgetary forecast targets for revenue growth and 50% on the achievement of set budgetary forecast targets for EBITDA.

Severance and Change in Control Benefits

Messrs. Ehrlich and Esses have a provision in their respective employment agreements providing for certain severance benefits in the event of termination or retirement, as well as a provision providing for a higher payment in the event of termination or retirement following a change in our control as defined in the employment agreement. These severance provisions are described in the “Employment Agreements” section below, and certain estimates of these change of control benefits are provided in “Estimated Payments and Benefits upon Termination” below.

We believe the severance arrangements that we have with Mr. Esses are at or near the median of executive officers with similar roles at public companies having comparable revenues. With respect to Mr. Ehrlich, we believe that his severance arrangements are at the high end of executive officers with similar roles at public companies having comparable revenues. However, with respect to Mr. Ehrlich, the Compensation Committee took note of (i) the historical contributions that Mr. Ehrlich has made to us during his career, including the fact that he was one of the founders of our company, (ii) the fact that Mr. Ehrlich has dedicated a substantial, and the latter, portion of his professional career to us, combined with (iii) the fact that we do not provide Mr. Ehrlich with any pension plan or other retirement plan other than the severance benefits provided under Israeli law (one month’s salary for each year of employment with us), which, while commonly the case among public companies of similar size and having comparable revenues, takes on added significance in respect of someone of Mr. Ehrlich’s age (68).

Benefits

Mr. Paup is eligible to participate in all of our employee benefit plans, such as medical, group life and disability insurance and our 401(k) plan, in each case on the same basis as our other U.S. employees. Our executive officers located in Israel have the pension, insurance, severance and other benefits described above that are legally required to be provided in Israel; their medical expenses are covered by Israel's national health funds.

Perquisites

All of our executive officers receive cellular telephones. We also pay a portion of the home telephone bills of our executive officers located in Israel, in view of the fact that the time difference between the United States and Israel causes them to do much work from their homes after normal business hours in Israel.

Our executive officers located in Israel receive use of a leased or purchased automobile and all attendant expenses, as is standard practice for executive officers in Israel. We also paid, on behalf of these executive officers, the Israeli tax to which they were subject because they had the use of these automobiles.

Pursuant to the terms of their employment agreements, our executive officers located in Israel also receive a tax planning allowance.

Our use of perquisites as an element of compensation is limited and is largely based on historical practices and policies of our company. We do not view perquisites as a significant element of our comprehensive compensation structure but do believe that they can be used in conjunction with base salary to attract, motivate and retain individuals in a competitive environment.

Cash and Other Compensation

Summary Compensation Table

The following table, which should be read in conjunction with the explanations provided above, shows the compensation that we paid (or accrued), in connection with services rendered for 2006, to our executive officers during the fiscal years ended December 31, 2006, 2005 and 2004:

SUMMARY COMPENSATION TABLE⁽¹⁾

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards ⁽²⁾ (\$)	Option Awards ⁽³⁾ (\$)	Non-Equity Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
Robert S. Ehrlich	2006	\$ 312,173	\$ 105,000	\$ 205,507	\$ -	\$ -	\$ 483,331 ⁽⁴⁾	\$1,106,011
Chairman, Chief Executive	2005	\$ 275,362	\$ 49,875	\$ 309,425	\$ -	\$ -	\$ 132,753 ⁽⁵⁾	\$ 767,415
Officer and a director	2004	\$ 275,907	\$ 99,750	\$ 103,918	\$ -	\$ 75,250	\$ 731,372 ⁽⁶⁾	\$1,286,197
Thomas J. Paup	2006	\$ 135,000	\$ 20,000	\$ -	\$ -	\$ -	\$ 2,596 ⁽⁷⁾	\$ 157,956
Vice President - Finance	2005	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
and	2004	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Chief Financial Officer								
Steven Esses	2006	\$ 62,211 ⁽⁸⁾	\$ 116,000 ⁽⁹⁾	\$ 65,421	\$ -	\$ -	\$ 252,929 ⁽¹⁰⁾	\$ 496,561
President, Chief Operating	2005	\$ 56,722 ⁽¹¹⁾	\$ 112,000 ⁽¹²⁾	\$ 110,550	\$ -	\$ -	\$ 277,123 ⁽¹³⁾	\$ 556,395
Officer and a director	2004	\$ 65,506 ⁽¹⁴⁾	\$ 106,000 ⁽¹⁵⁾	\$ 45,129	\$ -	\$ -	\$ 54,088 ⁽¹⁶⁾	\$ 270,723
Avihai Shen*	2006	\$ 41,601	\$ 0	\$ (27,585 ⁽¹⁷⁾)	\$ -	\$ -	\$ 15,567 ⁽¹⁸⁾	\$ 29,583
Former Vice President -							)	
Finance	2005	\$ 157,013	\$ 0	\$ 25,950	\$ -	\$ -	\$ 140,965 ⁽¹⁹⁾	\$ 327,928

and Chief Financial Officer	2004 \$	155,845 \$	97,000 \$	1,635 \$	- \$	- \$	68,743 ⁽²⁰⁾ \$	323,223

* Mr. Shen ceased to act as our Chief Financial Officer in February 2006, and his employment with us terminated on March 31, 2006.

⁽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.

- (2) Reflects the value of restricted stock awards granted to our executive officers based on the compensation cost of the award computed in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, which we refer to as SFAS 123R, but excluding any impact of assumed forfeiture rates. See Note 2.r. of the Notes to Consolidated Financial Statements. The number of shares of restricted stock received by our executive officers pursuant to such awards in 2006, vesting in equal amounts over three years, was as follows: Mr. Ehrlich, 320,000; Mr. Paup, 85,000; Mr. Esses, 160,000. The number of shares of restricted stock received by our executive officers pursuant to such awards in 2004, vesting in equal amounts over three years, was as follows: Mr. Ehrlich, 24,285; Mr. Esses, 11,785; Mr. Shen, 2,142. There were no such awards in 2005.
- (3) No options were issued in 2006. Amounts for 2005 and 2004 do not reflect compensation cost calculated in accordance with SFAS 123R since SFAS 123R had not been adopted as at such date. See Note 2.r. of the Notes to Consolidated Financial Statements for a discussion of the assumptions we made in determining the grant date fair value and compensation costs of our equity awards.
- (4) Of this amount, \$151,760 represents payments to Israeli pension and education funds; \$218,907 represents 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; \$26,689 represents the increase of the accrual for vacation days redeemable by Mr. Ehrlich; and \$21,217 represents the increase of our accrual for severance pay that would be payable to Mr. Ehrlich under the laws of the State of Israel if we were to terminate his employment.
- (5) Of this amount, \$45,362 represents payments to Israeli pension and education funds; \$67,024 represents 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; \$(51,928) represents the decrease of the accrual for vacation days redeemable by Mr. Ehrlich; \$(40,483) represents the decrease of the accrual for sick days redeemable by Mr. Ehrlich; \$(25,976) represents the decrease of our accrual for severance pay that would be payable to Mr. Ehrlich under the laws of the State of Israel if we were to terminate his employment; \$61,195 represents payment for redemption of accrued but unused vacation days; and \$33,394 represents payment for redemption of accrued but unused sick days.
- (6) Of this amount, \$548,477 represents payments to Israeli pension and education funds, \$500,000 of which was deposited by us in a Rabbi Trust for Mr. Ehrlich's benefit (pursuant to the terms of the Rabbi Trust, funds in the Rabbi Trust continue to be owned by us, and benefit from all gains and bear the risk of all losses resulting from investments of Rabbi Trust funds); \$76,766 represents our accrual for severance pay that would be payable to Mr. Ehrlich upon a "change of control" or upon the occurrence of certain other events; \$28,603 represents the increase of the accrual for vacation days redeemable by Mr. Ehrlich; and \$28,529 represents the increase of our accrual for severance pay that would be payable to Mr. Ehrlich under the laws of the State of Israel if we were to terminate his employment.
- (7) Represents the increase in our accrual for Mr. Paup for accrued but unused vacation days.
- (8) Does not include \$178,176 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) Does not include \$30,720 that we paid as a bonus 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.
- (10) Of this amount, \$112,627 represents payments to Israeli pension and education funds; and \$86,707 represents the increase of our accrual for severance pay that would be payable to Mr. Esses if we were to terminate his employment.

- (11) Does not include \$178,176 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.
- (12) Includes a \$100,000 signing bonus that was paid to Mr. Esses in 2005 and the \$12,000 minimum bonus to which Mr. Esses is entitled pursuant to the terms of his employment contract. Does not include \$30,720 that we paid as a bonus 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.
- (13) Of this amount, \$186,707 represents the increase of our accrual for severance pay that would be payable to Mr. Esses if we were to terminate his employment; and \$41,369 represents the increase of the accrual for sick leave and vacation days redeemable by Mr. Esses.
- (14) Does not include \$208,100 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.
- (15) Does not include \$110,000 that we paid as a bonus 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.
- (16) Of this amount, \$12,116 represents payments to Israeli pension and education funds; and \$3,759 represents the increase of the accrual for vacation days redeemable by Mr. Esses.
- (17) Represents recapture of expenses in respect of restricted stock that was returned to us upon termination of Mr. Shen's employment.
- (18) Of this amount, \$3,369 represents payment to Mr. Shen for redemption of accrued but unused vacation days.
- (19) Of this amount, \$26,889 represents payments to Israeli pension and education funds; \$104,602 represents the increase of our accrual for severance pay that would be payable to Mr. Shen if we were to terminate his employment; \$(28,597) represents the decrease of the accrual for sick leave and vacation days redeemable by Mr. Shen; \$(5,526) represents the decrease in our accrual for severance pay that would be payable to Mr. Shen under the laws of the State of Israel if we were to terminate his employment; and \$35,131 represents payment to Mr. Shen for redemption of accrued but unused vacation days. Mr. Shen left our employ effective March 31, 2006, and these amounts were accordingly paid to him.
- (20) Of this amount, \$26,889 represents payments to Israeli pension and education funds; \$21,568 represents the increase in our accrual for vacation days redeemable by Mr. Shen; and \$13,404 represents the increase of our accrual for severance pay that would be payable to Mr. Shen under the laws of the State of Israel if we were to terminate his employment.

Executive Loans

In 1999, 2000 and 2002, we extended certain loans to 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 Principal Amount of Loan	Amount Outstanding as of 12/31/06	Terms of Loan
Robert S. Ehrlich	12/28/99	\$ 167,975	\$ 201,570	Ten-year non-recourse loan to purchase our stock, secured by the shares of stock purchased.
Robert S. Ehrlich	02/09/00	\$ 789,991	\$ 766,027	Twenty-five-year non-recourse loan to purchase our stock, secured by the shares of stock purchased.
Robert S. Ehrlich	06/10/02	\$ 36,500	\$ 42,818	Twenty-five-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 2006.

Our executive officers did not exercise any stock options during 2006. The following table presents awards of restricted stock that vested during the year ended December 31, 2006.

STOCK VESTED

Name	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting ⁽¹⁾ (\$)
Robert S. Ehrlich	31,428	\$ 95,855
Steven Esses	11,785	\$ 35,944

⁽¹⁾ Reflects the aggregate market value of the shares of restricted stock determined based on a per share price of \$3.05, the closing price of our common stock on the Nasdaq Global Market on December 29, 2006, which was the last trading day of 2006.

Outstanding Equity Awards at Fiscal Year-End

The table below sets forth information for our executive officers with respect to option and restricted stock values at the end of the fiscal year ended December 31, 2006.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

Name	Option Awards				Stock Awards			
	Number of Securities Underlying Unexercised Options ⁽¹⁾ (#)		Option Exercise Price (\$)	Option Expiration Date	Number of Shares that Have Not Vested (#)	Market Value of Shares that Have Not Vested (2) (\$)	Equity Incentive Plan Awards	
							Number of Unearned Shares that Have Not Vested (#)	Market Value of Unearned Shares that Have Not Vested ⁽²⁾ (\$)
Robert S. Ehrlich	3,571 ⁽³⁾	0	\$ 5.46	08/09/09	80,000	\$244,000	240,000	\$ 732,000
	2,036 ⁽³⁾	0	\$ 5.46	10/31/09	-	-	-	-
	107,143	0	\$ 6.44	12/29/10	-	-	-	-
	11,857 ⁽³⁾	0	\$ 5.46	08/24/11	-	-	-	-
	3,428 ⁽³⁾	0	\$ 5.46	10/23/11	-	-	-	-
	5,179 ⁽³⁾	0	\$ 5.46	12/31/11	-	-	-	-
	4,687 ⁽³⁾	0	\$ 5.46	04/01/12	-	-	-	-
	1,116 ⁽³⁾	0	\$ 5.46	07/01/12	-	-	-	-
	4,688 ⁽³⁾	0	\$ 5.46	10/01/12	-	-	-	-
	6,295 ⁽³⁾	0	\$ 5.46	01/01/13	-	-	-	-
Thomas J. Paup	3,571 ⁽³⁾	0	\$ 5.18	12/31/10	21,250	\$ 64,813	63,750	\$ 194,438
Steven Esses	32,153 ⁽³⁾	0	\$ 5.46	02/24/08	40,000	\$122,000	120,000	\$ 366,000
	21,428 ⁽³⁾	0	\$ 5.46	12/31/08	-	-	-	-
	8,204 ⁽³⁾	0	\$ 5.46	12/29/10	-	-	-	-
	714	0	\$ 8.54	07/22/12	-	-	-	-
	1,786	0	\$ 11.62	07/22/12	-	-	-	-
	2,500 ⁽³⁾	0	\$ 5.46	01/31/13	-	-	-	-
	7,143 ⁽³⁾	0	\$ 5.46	07/09/13	-	-	-	-
Avihai Shen*	891	0	\$ 8.54	03/31/08	-	-	-	-

582	0 \$	10.22	10/15/14	-	-	-	-
582	0 \$	11.90	10/15/14	-	-	-	-
194	0 \$	18.20	10/15/14	-	-	-	-
582	0 \$	19.88	10/15/14	-	-	-	-

* Mr. Shen ceased to act as our Chief Financial Officer in February 2006, and his employment with us terminated on March 31, 2006.

- (1) All options in the table are vested.
- (2) Reflects the aggregate market value of the shares of restricted stock determined based on a per share price of \$3.05, the closing price of our common stock on the Nasdaq Global Market on December 29, 2006, which was the last trading day of 2006.
- (3) These options were renounced and abandoned by the named executive officer in February 2007.

Employment Contracts

Robert S. Ehrlich

Mr. Ehrlich is party to an employment agreement with us executed in April 2007. The term of this employment agreement expires on December 31, 2009.

The employment agreement provides for a base salary of \$33,333 per month, as adjusted annually for Israeli inflation and devaluation of the Israeli shekel against the U.S. dollar, if any. Additionally, the board may at its discretion raise Mr. Ehrlich's base salary. The employment agreement also grants Mr. Ehrlich a retention bonus in the amount of 200,000 shares of restricted stock, vesting one-third on each of December 31, 2007, 2008 and 2009.

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. For 2007, the Compensation Committee choose financial targets for determining eligibility for the above-referenced cash incentive bonus that are determined 50% on the achievement of set budgetary forecast targets for revenue growth and 50% on the achievement of set budgetary forecast targets for EBITDA, which is determined by taking net profit and adding back in interest expense (income), net (after deduction of minority interest), depreciation of fixed assets, taxes (after deduction of minority interest), and amortization of inventory adjustments and of intangible assets, capitalized software costs and technology impairment. New targets will be chosen for 2008 and 2009 based upon future budgetary forecasts.

The employment agreement also contains various benefits customary in Israel for senior executives (please see "Item 1. Business - Employees," above), 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 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, except that in the event of termination at the end of a contract term due to non-renewal by either party, and in the event of termination by Mr. Ehrlich on 120 days' prior notice, the severance pay will be only that amount that has vested (meaning that it had been scheduled to have been deposited in trust as described in the next paragraph). Furthermore, all outstanding options and certain of the restricted stock will be fully vested.

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 2006 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.

Pursuant to the terms of our employment agreement Mr. Ehrlich, funds to secure payment of Mr. Ehrlich's contractual severance are to be deposited for his benefit, with payments to be made pursuant to an agreed-upon schedule. As of December 31, 2006, a total of \$617,240 had been deposited. These funds continue to be owned by us, and we benefit from all gains and bear the risk of all losses resulting from investments of these funds.

Steven Esses

Mr. Esses is party to an employment agreement with us executed in May 2005, effective as of January 1, 2005. The term of this employment agreement, pursuant to an automatic extension, currently expires on December 31, 2008, and is extended automatically for additional terms of two years each unless either Mr. Esses or we terminate the agreement sooner.

The employment agreement provides for a base salary of \$5,000 per month, as adjusted annually for Israeli inflation and devaluation of the Israeli shekel against the U.S. dollar, if any. Additionally, the board may at its discretion raise Mr. Esses's base salary.

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. For 2007, the Compensation Committee choose financial targets for determining eligibility for the above-referenced cash incentive bonus that are determined 50% on the achievement of set budgetary forecast targets for revenue growth and 50% on the achievement of set budgetary forecast targets for EBITDA, which is determined by taking net profit and adding back in interest expense (income), net (after deduction of minority interest), depreciation of fixed assets, taxes (after deduction of minority interest), and amortization of inventory adjustments and of intangible assets, capitalized software costs and technology impairment. New targets will be chosen for 2008 based upon future budgetary forecasts.

The employment agreement also contains various benefits customary in Israel for senior executives (please see "Item 1. Business - Employees," above), 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, 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 in the amount of \$330,000, except that in the event of termination of the agreement following 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 termination, the amount payable is doubled. Furthermore, certain benefits will continue (for a shorter period, in the event of early retirement) and all outstanding options will be fully vested.

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 2006 under various circumstances appears under "Potential Payments and Benefits upon Termination of Employment - Steven Esses," below.

Pursuant to the terms of our employment agreement Mr. Esses, funds to secure payment of Mr. Esses's contractual severance are to be deposited for his benefit, with payments to be made pursuant to an agreed-upon schedule. As of December 31, 2006, a total of \$100,000 had been deposited. These funds continue to be owned by us, and we benefit from all gains and bear the risk of all losses resulting from investments of these funds.

See also "Item 13. Certain Relationships and Related Transactions - Consulting Agreement with Sampen Corporation," below.

Thomas J. Paup

Mr. Paup is party to an employment agreement with us dated December 30, 2005. Under the terms of his employment agreement, Mr. Paup is entitled to receive a base salary of \$135,000 per annum, and will be eligible for a bonus with a target equal to between 20% and 50% of the base salary. The actual bonus payout shall be determined based upon the Company's achievement level against financial and performance objectives determined by the Compensation Committee of our Board of Directors.

Avihai Shen - Severance Agreement

On December 30, 2005, we and Mr. Shen agreed that Mr. Shen would step down from his position as Vice President - Finance and Chief Financial Officer, effective no later than March 31, 2006. In connection with the departure of Mr. Shen from the position of Vice President - Finance and Chief Financial Officer, we and Mr. Shen executed a Separation Agreement dated January 5, 2006. Pursuant to the terms of this Separation Agreement, we made the following payments to Mr. Shen:

- \$81,884, representing statutory severance under the Israeli law;
- \$111,568, representing additional severance in the amount of (1) \$98,733, which was 7.9 months' salary at the annual salary rate of \$150,000 per year, and (2) \$12,835, which is the value of 7.9 months' of agreed benefits applicable to an annual salary rate of \$150,000 per year; and
- Payment in respect of accrued but unused vacation through the date of termination.

Mr. Shen has asserted that the terms of his Separation Agreement should be interpreted to provide him with an additional severance payment of approximately \$75,000. We have vigorously rejected this assertion, and are presently in arbitration with Mr. Shen on this issue.

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.

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 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.t. 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 29, 2006 (the last business day of the fiscal year).

Mr. Paup's employment agreement contains no provision with respect to payments or benefits upon termination of employment, and hence there is no tabular disclosure with respect to him below.

Mr. Shen, who left our employ in the first quarter of 2006, was not serving as one of our executive officers at the end of 2006. When Mr. Shen left our employ, in lieu of all benefits to which Mr. Shen might otherwise have been entitled, Mr. Shen received payments in accordance with the terms of the severance agreement entered into by him and us in January 2006, and hence there is no tabular disclosure with respect to him below. See "- Employment Contracts - Avihai Shen Severance Agreement," above, for a detailed discussion of such payments.

For a narrative description of the severance and change in control arrangements in the employment contracts of Messrs. Ehrlich and Esses, 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 employment agreement with us, as if his employment had terminated on December 29, 2006 (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	Non-Renewal (1)	Death or Disability (2)	Cause (3)	Good Reason (4)	Change of Control (5)	Retirement (6)	Termination at Will ⁽⁷⁾	Other Employee Termination (8)
Accrued but unpaid:								
Base salary	\$ 25,000	\$ 25,000	\$25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000
Bonus	6,960	6,960	6,960	6,960	6,960	6,960	6,960	6,960
Vacation	32,352	32,352	32,352	32,352	32,352	32,352	32,352	32,352
Recuperation pay ⁽⁹⁾	314	314	314	314	314	314	314	314
Benefits:								
Manager's insurance ⁽¹⁰⁾	3,958	3,958	3,958	3,958	3,958	3,958	3,958	3,958
Continuing education fund ⁽¹¹⁾	1,875	1,875	1,875	1,875	1,875	1,875	1,875	1,875
Tax gross-up on automobile	1,777	1,777	-	1,777	1,777	1,777	1,777	-
Contractual severance	1,218,750	1,625,400	-	1,625,400	3,250,800	1,625,400	1,218,750	-
Statutory severance ⁽¹²⁾	407,163	407,163	-	407,163	407,163	407,163	407,163	-
Benefits:								
Manager's insurance ⁽¹⁰⁾	142,470	142,470	-	142,470	142,470	142,470	142,470	-
Vacation	81,818	81,818	-	81,818	81,818	81,818	81,818	-
Continuing education fund ⁽¹²⁾	67,500	67,500	-	67,500	67,500	67,500	67,500	-
Automobile ⁽¹³⁾	42,857	42,857	-	42,857	42,857	42,857	42,857	-
Tax gross-up ⁽¹³⁾	57,858	57,858	-	57,858	57,858	57,858	57,858	-
TOTAL:	\$2,090,652	\$ 2,497,302	\$70,459	\$2,497,302	\$4,122,702	\$ 2,497,302	\$ 2,090,652	\$ 70,459

⁽¹⁾ “Non-renewal” is defined in Mr. Ehrlich’s employment agreement as a decision, made with written notice of at least 120 days in advance of the effective date of such decision, by either us or Mr. Ehrlich not to renew Mr. Ehrlich’s employment for an additional one-year term. Pursuant to the terms of Mr. Ehrlich’s employment agreement, in the absence of such notice, Mr. Ehrlich’s employment agreement automatically renews.

- (2) “Disability” is defined in Mr. Ehrlich’s employment agreement as a physical or mental infirmity which impairs the Mr. Ehrlich’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. 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.
- (4) “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) the insolvency or the filing (by any party, including us) of a petition for the winding-up of us; (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.
- (5) “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 $\frac{2}{3}$ 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 $\frac{1}{3}$ of our Board of us; 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) “Retirement” is not defined in Mr. Ehrlich’s employment agreement; in view of Mr. Ehrlich’s age at the time the employment agreement was negotiated and entered into, the concept of retirement was subsumed into Termination at Will.
- (7) “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.
- (8) “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.”
- (9) 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 318 (approximately \$75) per day.
- (10) 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 29, 2006, which funds are reflected in the table under the “Statutory severance” heading.
- (11) 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 29, 2006, the ceiling then in effect was NIS 15,712 (approximately \$3,720). 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.
- (12) 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.
- (13) Under the terms of Mr. Ehrlich’s employment agreement, we must under certain circumstances provide him with the use of the company car that he was driving at the time of termination for a period of time after termination and pay the tax on the benefit thereon. The taxable value of this use is reflected in the table.

Steven Esses

The following table describes the potential payments and benefits upon employment termination for Steven Esses, our President and Chief Operating Officer, pursuant to applicable law and the terms of his employment agreement with us, as if his employment had terminated on December 29, 2006 (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.

STEVEN ESSES

Payments and Benefits	Non-Renewal (1)	Death or Disability (2)	Cause (3)	Good Reason (4)	Change of Control (5)	Change of Location (6)	Retirement (7)	Early Retirement (8)	Other Employee Termination (9)
Accrued but unpaid ⁽¹⁰⁾									
Base salary	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000
Vacation	39,068	39,068	39,068	39,068	39,068	39,068	39,068	39,068	39,068
Sick leave ⁽¹¹⁾	17,455	17,455	-	17,455	17,455	17,455	17,455	17,455	-
Recuperation pay ⁽¹²⁾	188	188	188	188	188	188	188	188	188
Benefits:									
Manager’s insurance ⁽¹³⁾	792	792	792	792	792	792	792	792	792
Continuing education fund ⁽¹⁴⁾	1,335	1,335	1,335	1,335	1,335	1,335	1,335	1,335	1,335
Tax gross-up on automobile	1,912	1,912	-	1,912	1,912	1,912	1,912	1,912	-
Contractual severance	330,000	330,000	-	330,000	660,000	330,000	330,000	330,000	-
Statutory severance ⁽¹⁵⁾	16,198	16,198	-	16,198	16,198	16,198	16,198	16,198	-
Benefits:									
Manager’s insurance ⁽¹³⁾	9,498	9,498	-	9,498	9,498	9,498	9,498	9,498	-
Vacation	5,455	5,455	-	5,455	5,455	5,455	5,455	5,455	-
Continuing education fund ⁽¹⁴⁾	16,020	16,020	-	16,020	16,020	16,020	16,020	16,020	-
Automobile ⁽¹⁶⁾	10,128	10,128	-	10,128	10,128	10,128	10,128	10,128	-
Tax gross-up ⁽¹⁶⁾	12,440	12,440	-	12,440	12,440	12,440	12,440	12,440	-
TOTAL:	\$ 465,489	\$ 465,489	\$ 46,383	\$ 465,489	\$ 795,489	\$ 465,489	\$ 465,489	\$ 465,489	\$ 46,383

⁽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 the 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) the insolvency or the filing (by any party, including us) of a petition for the winding-up of us; (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 $\frac{2}{3}$ 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 $\frac{1}{3}$ of our Board of us; 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 \$12,800 in accrued but unpaid consulting fees due at December 29, 2006 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.
- (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 318 (approximately \$75) 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 29, 2006, 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 29, 2006, the ceiling then in effect was NIS 15,712 (approximately \$3,720). 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.

(16) Under the terms of Mr. Esses's employment agreement, we must under certain circumstances provide him with the use of the company car that he was driving at the time of termination for a period of time after termination and pay the tax on the benefit thereon. The taxable value of this use is reflected in the table.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee of our board of directors for the 2006 fiscal year consisted of Dr. Jay M. Eastman, Jack E. Rosenfeld and Edward J. Borey. None of the members has served as our officers or employees.

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, 2007, 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 Beneficially Owned⁽²⁾⁽³⁾	Percentage of Total Shares Outstanding⁽³⁾
Robert S. Ehrlich	529,466 ⁽⁴⁾	4.4%
Steven Esses	245,713 ⁽⁵⁾	2.0%
Thomas J. Paup	88,571 ⁽⁶⁾	*
Dr. Jay M. Eastman	8,571 ⁽⁷⁾	*
Jack E. Rosenfeld	8,713 ⁽⁸⁾	*
Lawrence M. Miller	32,693 ⁽⁹⁾	*
Edward J. Borey	6,142 ⁽¹⁰⁾	*
Prof. Seymour Jones	1,190 ⁽¹¹⁾	*
All of our directors and executive officers as a group (8 persons)	921,060 ⁽¹²⁾	7.5%

* 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 11,983,576 shares of common stock outstanding as of February 28, 2007. 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 44,154 shares held directly by Mr. Ehrlich, 320,000 shares of unvested restricted stock (in which shares Mr. Ehrlich disclaims beneficial ownership), 3,571 shares held by Mr. Ehrlich's wife (in which shares Mr. Ehrlich disclaims beneficial ownership), 11,527 shares held in Mr. Ehrlich's pension plan, 214 shares held by children sharing the same household (in which shares Mr. Ehrlich disclaims beneficial ownership), and 150,000 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.

(5) Consists of 11,785 shares held directly by Mr. Esses, 160,000 shares of unvested restricted stock (in which shares Mr. Esses disclaims beneficial ownership), and 73,928 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.

(6) Consists of 85,000 shares of unvested restricted stock (in which shares Mr. Paup disclaims beneficial ownership) and 3,571 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.

(7) Consists of 8,571 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.

(8) Consists of 142 shares owned directly by Mr. Rosenfeld and 8,571 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.

- (9) Consists of 23,271 shares held by Mr. Miller as trustee of the Rose Gross Charitable Foundation, in which shares Mr. Miller disclaims beneficial ownership, 851 shares held directly by Mr. Miller, and 8,571 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.
- (10) Consists of 1,142 shares owned directly by Mr. Borey and 5,000 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.
- (11) Consists of 1,190 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.
- (12) Includes 259,402 shares issuable upon exercise of options exercisable within 60 days of February 28, 2007.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth certain information, as of December 31, 2006, with respect to our 1991, 1993, 1995, 1998 and 2004 stock option 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 (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders ⁽¹⁾	1,535,829	\$ 3.33	310,174

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

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Officer Loans

On December 3, 1999, Robert S. Ehrlich purchased 8,928 shares of our common stock out of our treasury at the closing price of the common stock on December 2, 1999. Payment was rendered by Mr. Ehrlich in the form of non-recourse promissory notes due in 2009 in the amount of \$167,975, bearing simple annual interest at a rate of 2%, secured by the shares of common stock purchased and other shares of common stock previously held by him. As of December 31, 2006, the aggregate amount outstanding pursuant to this promissory note was \$201,570.

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 \$789,991, bearing annual interest (i) as to \$329,163, at 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*, and (ii) as to \$460,828, at 4% over the then-current percentage increase in the Israeli consumer price index between the date of the loan and the date of the annual interest calculation, 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, 2006, the aggregate amount outstanding pursuant to this promissory note was \$766,027.

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, 2006, the aggregate amount outstanding pursuant to this promissory note was \$42,818.

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 expires on December 31, 2008, and is extended automatically for additional terms of two years each unless either Sampen or we terminate the agreement sooner.

Pursuant to the terms of our agreement with Sampen, Sampen provides one of its employees to us for such employee to serve as our Chief Operating Officer. 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.

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 Seidman, 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. Prior to June 20, 2006, when BDO was retained by us as our independent accountants, Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, served as our independent accountants.

- *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, 2006 and 2005 totaled approximately \$456,000 and \$0, respectively.
- *Audit-Related Fees.* BDO billed us \$15,000 and \$0 for the fiscal years ended December 31, 2006 and 2005, respectively, for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements.

- *Tax Fees.* BDO billed us \$9,000 and \$0 for the fiscal years ended December 31, 2006 and 2005, respectively, for tax services.
- *All Other Fees.* The Audit Committee of the Board of Directors has considered whether the provision of the Audit-Related Fees, Tax Fees and all other fees are compatible with maintaining the independence of our principal accountant.

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.

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

Exhibit No.	Description
(1) 3.1	Amended and Restated Certificate of Incorporation
(4) 3.1.1	Amendment to our Amended and Restated Certificate of Incorporation
(13) 3.1.2	Amendment to our Amended and Restated Certificate of Incorporation
(14) 3.1.3	Amendment to our Amended and Restated Certificate of Incorporation
(24) 3.1.4	Amendment to our Amended and Restated Certificate of Incorporation
(2) 3.2	Amended and Restated By-Laws
(14) 4.1	Specimen Certificate for shares of common stock, \$.01 par value
† (1) 10.1.1	Form of Management Employment Agreements
† * (1) 10.1.2	General Employee Agreements
* (1) 10.2	Office of Chief Scientist documents
(2) 10.2.1	Letter from the Office of Chief Scientist to us dated January 4, 1995
(20) 10.3	Promissory Note dated December 3, 1999, from Robert S. Ehrlich to us
(20) 10.4	Promissory Note dated February 9, 2000, from Robert S. Ehrlich to us
(20) 10.5	Promissory Note dated January 12, 2001, from Robert S. Ehrlich to us
(3) 10.6	Form of Common Stock Purchase Warrant dated May 8, 2001
(4) 10.7	Securities Purchase Agreement dated December 31, 2002 between us and the Investors
(4) 10.8	Form of 9% Secured Convertible Debenture due June 30, 2005
(4) 10.9	Form of Warrant dated December 31, 2002
(4) 10.10	Form of Security Agreement dated December 31, 2002

- (4) 10.11 Form of Intellectual Property Security Agreement dated December 31, 2002
- †(5) 10.12 Settlement Agreement and Release between us and Yehuda Harats dated December 31, 2002
- (5) 10.13 Commercial lease agreement between Commerce Square Associates L.L.C. and I.E.S. Electronics Industries U.S.A., Inc. dated September 24, 1997

Exhibit No.	Description
(5) 10.14	Amendment to Commercial lease agreement between Commerce Square Associates L.L.C. and I.E.S. Electronics Industries U.S.A., Inc. dated as of May 1, 2000
(5) 10.15	Agreement of Lease dated December 6, 2000 between Janet Nissim <i>et al.</i> and M.D.T. Protection (2000) Ltd. [English summary of Hebrew original]
(5) 10.16	Agreement of Lease dated August 22, 2001 between Aviod Building and Earthworks Company Ltd. <i>et al.</i> and M.D.T. Protective Industries Ltd. [English summary of Hebrew original]
(6) 10.17	Securities Purchase Agreement dated September 30, 2003 between us and the Investors named therein
(19) 10.17.1	Amendment Agreement dated February 15, 2006 between us and Smithfield Fiduciary LLC
(6) 10.18	Form of 8% Secured Convertible Debenture due September 30, 2006
(6) 10.19	Form of Warrant dated September 30, 2003
(6) 10.20	Form of Security Agreement dated September 30, 2003
(6) 10.21	Form of Intellectual Property Security Agreement dated September 30, 2003
(7) 10.22	Form of Amendment and Exercise Agreement dated December 10, 2003
(7) 10.23	Form of Supplemental Warrant dated December 18, 2003
(8) 10.24	Stock Purchase and Sale Agreement dated January 7, 2004 between us and the stockholders of FAAC Incorporated
(8) 10.25	Securities Purchase Agreement dated January 7, 2004 between us and the Investors named therein
(8) 10.26	Registration Rights Agreement dated January 7, 2004 between us and the Investors named therein
(8) 10.27	Form of Warrant dated January __, 2004
(9) 10.28	Share Purchase Agreement dated January __, 2004 between us and the stockholders of Epsilor Electronics Industries, Ltd.
(9) 10.29	Management Agreement dated January __, 2004 among us, Office Line Ltd. and Hezy Aspis
*(10) 10.30	Settlement Agreement between us and I.E.S. Electronics Industries, Ltd. dated February 4, 2004
†(11) 10.31	Consulting agreement dated January 1, 2004 between us and Edward J. Borey
(11) 10.32	Promissory Note dated July 1, 2002 from Robert S. Ehrlich to us
(11) 10.33	Lease dated April 8, 1997, between AMR Holdings, L.L.C. and FAAC Incorporated
(11) 10.34	Lease dated as of March 22, 2004 between us and Fisk Building Associates L.L.C.
(12) 10.35	Stock Purchase Agreement dated as of July 15, 2004 between us and Armour of America, Incorporated and its sole stockholder
(13) 10.36	Securities Purchase Agreement dated as of July 15, 2004, by and among us and various investors

	Exhibit No.	Description
†(14)	10.37	Consulting Agreement, effective as of January 1, 2005, between us and Sampen Corporation
† **	10.38	Fourth Amended and Restated Employment Agreement, dated April 16, 2007, between us, EFL and Robert S. Ehrlich
†(15)	10.39	Employment Agreement, effective as of January 1, 2005 between EFL and Steven Esses
(16)	10.40	Stock Purchase Agreement dated as of May 17, 2005, by and among us and various purchasers
(17)	10.41	Securities Purchase Agreement dated September 29, 2005 between us and the Investors named therein
(22)	10.41.1	Conversion Agreement dated April 7, 2006 between us and the Investors named therein
(17)	10.42	Form of Senior Secured Convertible Note due March 31, 2008
(17)	10.43	Form of Warrant dated September 29, 2005
(17)	10.44	Form of Security Agreement dated September 29, 2005
(17)	10.45	Form of Intellectual Property Security Agreement dated September 29, 2005
† (18)	10.46	Employment Agreement between the Company and Thomas J. Paup dated December 30, 2005
† (18)	10.47	Separation Agreement and Release of Claims among the Company, EFL and Avihai Shen dated January 5, 2006
(19)	10.48	Form of Warrant dated February 15, 2006
(20)	10.49	Lease dated February 10, 2006 between Arbor Development Company LLC and FAAC Incorporated
(21)	10.50	Form of Warrant dated March 27, 2006
(23)	10.51	Form of Warrant dated April 11, 2006
(14)	21.1	List of Subsidiaries of the Registrant
**	23.1	Consent of BDO Seidman, LLP
**	23.2	Consent of Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global
**	23.3	Consent of Stark Winter Schenkein & Co., LLP
**	31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**	31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**	32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
**	32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* English translation or summary from original Hebrew

** 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 May 7, 2001 (EDGAR Film No. 1623989)
- (4) Incorporated by reference to our Current Report on Form 8-K filed January 6, 2003
- (5) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2002
- (6) Incorporated by reference to our Current Report on Form 8-K filed October 3, 2003
- (7) Incorporated by reference to our Current Report on Form 8-K filed December 23, 2003
- (8) Incorporated by reference to our Current Report on Form 8-K filed January 9, 2004
- (9) Incorporated by reference to our Current Report on Form 8-K filed February 4, 2004
- (10) Incorporated by reference to our Current Report on Form 8-K filed February 5, 2004
- (11) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2003
- (12) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004
- (13) Incorporated by reference to our Current Report on Form 8-K filed July 15, 2004
- (14) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2004
- (15) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004
- (16) Incorporated by reference to our Current Report on Form 8-K filed May 17, 2005
- (17) Incorporated by reference to our Current Report on Form 8-K filed September 30, 2005
- (18) Incorporated by reference to our Current Report on Form 8-K filed January 5, 2006
- (19) Incorporated by reference to our Current Report on Form 8-K filed February 16, 2006
- (20) Incorporated by reference to our Annual Report on Form 10-K for the year ended December 31, 2005
- (21) Incorporated by reference to our Current Report on Form 8-K filed March 30, 2006
- (22) Incorporated by reference to our Current Report on Form 8-K filed April 7, 2006
- (23) Incorporated by reference to our Current Report on Form 8-K filed April 12, 2006
- (24) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006

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, on April 16, 2007.

AROTECH CORPORATION

By: /s/ Robert S. Ehrlich

Name: Robert S. Ehrlich

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 Robert S. Ehrlich	Chairman Chief Executive Officer and Director (Principal Executive Officer)	April 16, 2007
_____ /s/ Thomas J. Paup Thomas J. Paup	Vice President - Finance (Principal Financial Officer)	April 16, 2007
_____ /s/ Norman Johnson Norman Johnson	Controller (Principal Accounting Officer)	April 16, 2007
_____ /s/ Steven Esses Steven Esses	President, Chief Operating Officer and Director	April 16, 2007
_____ /s/ Jay M. Eastman Dr. Jay M. Eastman	Director	April 16, 2007
_____ /s/ Lawrence M. Miller Lawrence M. Miller	Director	April 16, 2007
_____ /s/ Jack E. Rosenfeld Jack E. Rosenfeld	Director	April 16, 2007
_____ /s/ Edward J. Borey Edward J. Borey	Director	April 16, 2007
_____ /s/ Seymour Jones Seymour Jones	Director	April 16, 2007

 IDBO

BDO Seidman, LLP
Accountants and Consultants

99 Monroe Ave. NW, Suite 800
Grand Rapids, MI 49503-2698

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Arotech Corporation:

We have audited the accompanying consolidated balance sheet of Arotech Corporation and subsidiaries as of December 31, 2006, and the related consolidated statements of operation, changes in stockholders' equity and cash flows for the year then ended. Our audit also included the financial statement schedule listed in the index at Item 15(a)2. 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 audit.

We conducted our audit 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 audit 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 and schedule, 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 audit provides 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 as of December 31, 2006, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the financial statement schedule presents fairly, in all material respects, the information set forth therein.

Grand Rapids, Michigan
April 15, 2007

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■ **Kost Forer Gabbay & Kasierer**
3 Aminadav St.
Tel-Aviv 67067, Israel

■ Phone: 972-3-6232525
Fax: 972-3-5622555

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of

AROTECH CORPORATION

We have audited the accompanying consolidated balance sheets of Arotech Corporation (the "Company") and its subsidiaries as of December 31, 2005, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the two years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in Item 15(a)(2) of the Company's Form 10-K. 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 did not audit the financial statements of "Armor of America Incorporated," a wholly-owned subsidiary of the Company, which statements reflect total assets of 2.8% of the consolidated assets of the Company as of December 31, 2005, and total revenues of 8.8% and 5% of the consolidated revenues of the Company for the years ended December 31, 2005 and 2004, respectively. We also did not audit the financial statements of "IES Interactive Training, Inc.," a wholly-owned subsidiary of the Company, which statements reflect total assets of 3.5% of the consolidated assets of the Company as of December 31, 2005, and total revenues of 11.8% of the consolidated revenues of the Company for the year then ended. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the data included for these subsidiaries, is based solely on the reports of the other auditors.

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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2005, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Additionally, in our opinion based on our audits, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Tel Aviv, Israel
March 30, 2006

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



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
IES Interactive Training, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of IES Interactive Training, Inc. and Subsidiary as of December 31, 2005, and the related consolidated statements of operations, stockholder's (deficit) and cash flows for the year ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that IES Interactive Training, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). IES Interactive Training, Inc. and Subsidiary's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit 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 and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included 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, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

STARK ♦ WINTER ♦ SCHENKEIN & CO., LLP ♦ *Certified Public Accountants ♦ Financial Consultants*

7535 EAST HAMPDEN AVENUE ♦ SUITE 109 ♦ DENVER, COLORADO 80231
PHONE: 303.694.6700 ♦ FAX: 303.694.6761 ♦ TOLL FREE: 888.766.3985 ♦ WWW.SWSCPAS.COM



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of IES Interactive Training, Inc. and Subsidiary as of December 31, 2005, and the results of its operations and its cash flows for the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that IES Interactive Training, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, IES Interactive Training, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Stark Winter Schenkein & Co., LLP

Denver, Colorado

March 10, 2006

STARK ♦ WINTER ♦ SCHENKEIN & CO., LLP ♦ *Certified Public Accountants ♦ Financial Consultants*

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Report of Independent Registered Public Accounting Firm

To the Shareholder
Armour of America, Inc.
Gardena, California

We have audited the accompanying balance sheet of Armour of America, Inc. as of December 31, 2005, and the related statements of operations, stockholder's equity and cash flows for the period August 11, 2004 to December 2004 and the year ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Armour of America, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Armour of America, Inc.'s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included 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, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

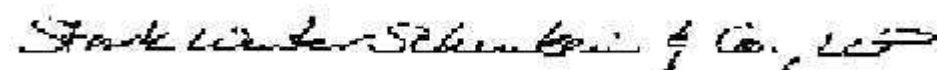
A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Armour of America, Inc. as of December 31, 2005, and the related statements of operations, stockholder's equity and cash flows for the period August 11, 2004 to December 2004 and the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, management's assessment that Armour of America, Inc. maintained effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, Armour of America, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).



Denver, Colorado
January 31, 2006

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AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
In U.S. dollars

	December 31,	
	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 2,368,872	\$ 6,150,652
Restricted collateral deposits and restricted held-to-maturity securities	648,975	3,897,113
Escrow receivable	1,479,826	-
Available for sale marketable securities	41,166	35,984
Trade receivables (net of allowance for doubtful accounts in the amounts of \$159,000 and \$176,000 as of December 31, 2006 and 2005, respectively)	7,780,965	11,747,876
Unbilled receivables	6,902,533	5,228,504
Other accounts receivable and prepaid expenses	1,134,622	2,264,331
Inventories	7,851,820	7,815,806
Total current assets	28,208,779	37,140,266
SEVERANCE PAY FUND	2,246,457	2,072,034
OTHER LONG TERM RECEIVABLES	262,608	-
RESTRICTED DEPOSITS	-	779,286
PROPERTY AND EQUIPMENT, NET	3,740,593	4,252,931
INVESTMENT IN AFFILIATED COMPANY	392,398	37,500
OTHER INTANGIBLE ASSETS, NET	9,502,214	11,027,499
GOODWILL	30,715,225	29,559,157
	<u>\$ 75,068,274</u>	<u>\$ 84,868,673</u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

In U.S. dollars

	December 31,	
	2006	2005
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 2,808,131	\$ 5,830,820
Other accounts payable and accrued expenses	5,171,055	5,630,108
Current portion of capitalized leases	55,263	-
Current portion of promissory notes due to purchase of subsidiaries	302,900	603,764
Short term bank credit and current portion of long term loans	3,496,008	2,036,977
Deferred revenues	1,321,311	603,022
Convertible debenture	2,583,629	11,492,238
Liabilities of discontinued operations	-	120,000
Total current liabilities	15,738,297	26,316,929
LONG TERM LIABILITIES		
Accrued severance pay	4,039,049	3,657,328
Long term portion of promissory notes due to purchase of subsidiaries	151,450	-
Long term portion of capitalized leases	158,120	-
Convertible debenture	-	8,590,233
Total long-term liabilities	4,348,619	12,247,561
COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)		
MINORITY INTEREST		
	21,520	38,927
STOCKHOLDERS' EQUITY:		
Share capital -		
Common stock - \$0.01 par value each;		
Authorized: 250,000,000 shares as of December 31, 2006 and 2005; Issued: 12,023,242 shares and 6,221,194 shares as of December 31, 2006 and 2005, respectively;		
Outstanding - 11,983,576 shares and 6,181,527 shares as of December 31, 2006 and 2005, respectively	120,232	870,969
Preferred shares - \$0.01 par value each;		
Authorized: 1,000,000 shares as of December 31, 2006 and 2005; No shares issued and outstanding as of December 31, 2006 and 2005	-	-
Additional paid-in capital	217,735,860	193,560,579
Accumulated deficit	(158,566,123)	(142,996,964)
Treasury stock, at cost (common stock - 39,666 shares as of December 31, 2006 and 2005)	(3,537,106)	(3,537,106)
Notes receivable from stockholders	(1,304,179)	(1,256,777)
Accumulated other comprehensive income (loss)	511,154	(375,445)
Total stockholders' equity	54,959,838	46,265,256

\$	75,068,274	\$	84,868,673

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

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AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

In U.S. dollars

	Year ended December 31,		
	2006	2005	2004
Revenues	\$ 43,120,739	\$ 49,044,595	\$ 49,953,846
Cost of revenues	32,493,646	34,383,736	34,011,094
Operating expenses:			
Research and development, net	1,601,454	1,300,429	1,731,379
Selling and marketing expenses	3,714,322	4,471,590	4,922,217
General and administrative expenses	11,692,816	14,862,435	10,656,866
Amortization of intangible assets	1,853,442	3,070,748	2,494,556
Impairment of goodwill and other intangible assets	316,024	12,256,756	320,279
Total operating costs and expenses	19,178,058	35,961,958	20,125,297
Operating loss	(8,550,965)	(21,301,099)	(4,182,545)
Other income	361,560	338,900	-
Financial expenses, net	(7,519,900)	(2,705,689)	(4,228,965)
Loss before minorities interests in earnings of a subsidiaries and tax expenses	(15,709,305)	(23,667,888)	(8,411,510)
Income taxes	(232,159)	(237,672)	(586,109)
Gain (loss) from affiliated company	354,898	(75,000)	-
Minorities interests in loss (earnings) of a subsidiaries	17,407	57,149	(44,694)
Loss from continuing operations	(15,569,159)	(23,923,411)	(9,042,313)
Loss from discontinued operations	-	(120,000)	-
Net loss	\$ (15,569,159)	\$ (24,043,411)	\$ (9,042,313)
Deemed dividend to certain stockholders	\$ (434,185)	\$ -	\$ (3,328,952)
Net loss attributable to common stockholders	\$ (16,003,344)	\$ (24,043,411)	\$ (12,371,265)
Basic and diluted net loss per share from continuing operations	\$ (1.87)	\$ (4.07)	\$ (2.48)
Basic and diluted net profit (loss) per share from discontinued operations	\$ 0.00	\$ (0.02)	\$ 0.00
Basic and diluted net loss per share	\$ (1.87)	\$ (4.09)	\$ (2.48)
Weighted average number of shares used in computing basic and diluted net loss per share	8,569,191	5,872,093	4,995,218

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock		Additional paid-in	Accumulated	Deferred stock	Treasury	Notes receivable from	Accumulated other comprehensive	Total comprehensive	Total stockholders'
	Shares	Amount	capital	deficit	compensation	stock	stockholders	loss	income	equity
Balance as of January 1, 2004	3,426,601	\$479,726	\$135,702,413	\$(109,911,240)	\$ (8,464)	\$(3,537,106)	\$ (1,203,881)	\$ 104,429		\$ 21,625,877
Issuance of shares, net	1,009,892	141,384	24,252,939	-	-	-	-	-		24,394,323
Issuance of shares and warrants due to settlement of litigation	32,143	4,500	1,244,328	-	-	-	-	-		1,248,828
Issuance of shares to employees	2,857	400	92,800	-	-	-	-	-		93,200
Conversion of convertible debentures	274,552	38,437	3,754,279	-	-	-	-	-		3,792,716
Exercise of warrants by investors and others	811,667	113,633	19,119,638	-	-	-	-	-		19,233,271
Issuance of shares to consultants	6,444	902	198,489	-	-	-	-	-		199,391
Reclassification to liability in connection with warrants granted	-	-	(10,841,020)	-	-	-	-	-		(10,841,020)
Reclassification of liability to equity related to the fair value of warrants	-	-	10,514,181	-	-	-	-	-		10,514,181
Compensation related to non-recourse loan granted to shareholder	-	-	(10,000)	-	-	-	-	-		(10,000)
Deferred stock com-pensation related to options and restricted stock	52,857	7,400	2,074,057	-	(2,081,457)	-	-	-		-
Amortization of deferred stock com-pensation				-	831,626	-	-	-		831,626
Exercise of options by employees	64,089	8,972	1,101,172	-	-	-	-	-		1,110,144
Exercise of options by consultants	2,687	376	50,799	-	-	-	-	-		51,175
Issuance of shares in respect of FAAC acquisition	71,704	10,039	1,993,639	-	-	-	-	-		2,003,678
Accrued interest on notes receivable from stockholders	-	-	18,990	-	-	-	(18,990)	-		-
Other comprehensive income - foreign currency translation adjustment	-	-	-	-	-	-	-	263,404	\$ 263,404	263,404
Other comprehensive income - realized gain on available for sale marketable securities	-	-	-	-	-	-	-	4,502	4,502	4,502
Net loss	-	-	-	(9,042,313)	-	-	-	-	(9,042,313)	(9,042,313)
									\$ (8,774,407)	
Balance as of December 31, 2004	5,755,493	\$805,769	\$189,266,704	\$(118,953,553)	\$ (1,258,295)	\$(3,537,106)	\$ (1,222,871)	\$ 372,335		\$ 65,472,983

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock		Additional paid-in	Accumulated	Deferred stock	Treasury	Notes receivable from	Accumulated other comprehensive income	Total comprehensive income	Total stockholders'
	Shares	Amount	capital	deficit	compensation	stock	stockholders	(loss)	(loss)	equity
Balance as of January 1, 2005	5,759,786	\$ 806,370	\$189,266,103	\$ (118,953,553)	\$ (1,258,295)	\$(3,537,106)	\$(1,222,871)	\$ 372,335	\$ -	\$ 65,472,983
Issuance of shares, net	339,640	47,551	3,898,185	-	-	-	-	-	-	3,945,736
Shares issued to convertible debenture holders	82,976	11,617	441,434	-	-	-	-	-	-	453,051
Shares issued to consultant	36,232	5,073	516,200	-	-	-	-	-	-	521,273
Compensation related to non-recourse loan granted to shareholder	-	-	(28,500)	-	-	-	-	-	-	(28,500)
Employee options exercise	1,132	158	17,034	-	-	-	-	-	-	17,192
Shares issued to employees	714	100	(100)	-	-	-	-	-	-	-
Deferred stock compensation related to options and restricted stock	3,571	500	50,500	-	(51,000)	-	-	-	-	-
Amortization of deferred stock compensation	-	-	-	-	674,712	-	-	-	-	674,712
Cancellation of deferred stock compensation as a result of forfeitures	(2,857)	(400)	(244,880)	-	245,280	-	-	-	-	-
Interest accrued on notes receivable from shareholders	-	-	33,906	-	-	-	(33,906)	-	-	-
Other comprehensive loss - foreign currency translation adjustment	-	-	-	-	-	-	-	(746,016)	(746,016)	(746,016)
Other comprehensive loss - unrealized gain on available for sale marketable securities	-	-	-	-	-	-	-	(1,764)	(1,764)	(1,764)
Net loss	-	-	-	(24,043,411)	-	-	-	-	(24,043,411)	(24,043,411)
Total comprehensive loss	-	-	-	-	-	-	-	-	(24,791,191)	-
Balance as of December 31, 2005	6,221,194	\$ 870,969	\$193,949,882	\$ (142,996,964)	\$(389,303)	\$(3,537,106)	\$(1,256,777)	\$(375,445)		\$ 46,265,256

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

In U.S. dollars

	Common stock		Additional	Accumulated	Deferred	Treasury	Notes	Accumulated	Total	Total
	Shares	Amount	paid-in	deficit	stock	stock	receivable	other	comprehensive	stockholders'
			capital		compensation		from	comprehensive	income	equity
							stockholders	income	(loss)	
								(loss)		
Balance as of										
January 1, 2006	6,221,194	\$ 870,969	\$193,949,882	\$ (142,996,964)	\$ (389,303)	\$(3,537,106)	\$ (1,256,777)	\$ (375,445)	-	\$ 46,265,256
Reclassification of common stock due to reverse stock split	(142)	(808,757)	808,757	-	-	-	-	-	-	-
FAS 123R reclassification	-	-	(389,303)	-	389,303	-	-	-	-	-
Principal installment of convertible debenture payment in shares	4,184,855	41,848	18,477,301	-	-	-	-	-	-	18,519,149
Warrants exercise	745,549	7,455	4,343,180	-	-	-	-	-	-	4,350,635
Amortization of deferred stock compensation	-	-	500,545	-	-	-	-	-	-	500,545
Stock options and restricted stock	871,786	8,717	(1,904)	-	-	-	-	-	-	6,813
Interest accrued on notes receivable from shareholders	-	-	47,402	-	-	-	(47,402)	-	-	-
Other comprehensive loss - foreign currency translation adjustment	-	-	-	-	-	-	-	885,733	885,733	885,733
Other comprehensive loss - unrealized gain on available for sale marketable securities	-	-	-	-	-	-	-	866	866	866
Net loss	-	-	-	(15,569,159)	-	-	-	-	(15,569,159)	(15,569,159)
Total comprehensive loss	-	-	-	-	-	-	-	-	(14,682,560)	-
Balance as of December 31, 2006	12,023,242	\$ 120,232	\$217,735,860	\$ (158,566,123)	-	\$(3,537,106)	\$ (1,304,179)	511,154	-	\$ 54,959,838

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

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

	Year ended December 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net loss	\$ (15,569,159)	\$ (24,043,411)	\$ (9,042,313)
Less loss for the period from discontinued operations	-	120,000	-
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minorities interests in earnings (loss) of subsidiary	(17,407)	(57,149)	44,694
Loss (gain) from affiliated company	(354,898)	75,000	-
Depreciation	1,966,748	1,373,580	1,199,465
Amortization of intangible assets, capitalized software costs and impairment of intangible assets	2,857,891	15,453,584	2,888,226
Remeasurement of liability in connection to warrants granted	(700,113)	(377,803)	(326,839)
Accrued severance pay, net	194,810	68,839	(441,610)
Compensation related to shares issued to employees and directors	500,545	674,713	884,826
Mark up of loans to stockholders	-	-	(32,397)
Write-off of inventories	292,864	1,062,336	121,322
Impairment of property and equipment	32,485	34,243	-
Financial expenses in connection with convertible debenture principle repayment	5,395,338	-	-
Amortization related to warrants issued to the holders of convertible debentures and beneficial conversion feature	1,485,015	1,702,753	4,142,109
Amortization deferred charges related to convertible debentures issuance	780,719	329,152	222,732
Stock-based compensation related to shares issued and to be issued to consultants and shares granted as a donation	6,536	538,058	89,078
Stock-based compensation related to non-recourse note granted to stockholder	-	(28,500)	(10,000)
Interest accrued or paid on promissory notes due to acquisition	-	19,704	39,311
Interest accrued on restricted collateral deposits	-	-	(267,179)
Capital loss (gain) from sale of marketable securities	-	2,695	(4,247)
Amortization of premium related to restricted held to maturity securities	-	42,234	202,467
Capital loss (gain) from sale of property and equipment	(1,842)	3,172	(16,479)
Decrease (increase) in trade receivables	3,631,978	(3,608,950)	732,828
Decrease (increase) in other accounts receivable and prepaid expenses	605,610	(75,982)	(49,513)
Decrease (increase) in deferred tax assets	6,788	65,376	(89,823)
Increase in inventories	(208,938)	(1,710,528)	(2,040,854)
Increase in unbilled revenues	(1,674,029)	(2,347,036)	(1,581,080)
Decrease (increase) in deferred revenues	718,290	(178,988)	(91,271)
Increase (decrease) in trade payables	(3,156,665)	(224,987)	2,913,623
Increase (decrease) in other accounts payable and accrued expenses	(296,866)	32,269	(125,231)
Net cash used in operating activities from continuing operations	(3,504,300)	(11,055,626)	(638,155)
Net cash used in operating activities from discontinued operations	(120,000)	-	(214,041)
Net cash used in operating activities	\$ (3,624,300)	\$ (11,055,626)	\$ (852,196)

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

In U.S. dollars

	Year ended December 31,		
	2006	2005	2004
Cash flows from investing activities:			
Purchase of property and equipment	(1,412,383)	(1,224,752)	(1,659,688)
Increase in capitalized software costs	(688,443)	(651,611)	(365,350)
Loans granted to stockholders	-	-	(1,036)
Repayment of loans granted to stockholders	-	-	32,397
Proceeds from sale of property and equipment	-	104,175	114,275
Proceeds from sale of marketable securities	-	91,936	90,016
Investment in marketable securities	-	-	(89,204)
Investment in affiliated company	-	(112,500)	-
Payment of additional required payout for FAAC acquisition	(630,350)	(12,945)	-
Acquisition of Epsilon (1)	-	-	(7,190,777)
Acquisition of FAAC (2)	-	-	(12,129,103)
Acquisition of AoA (3)	-	-	(17,339,522)
Repayment of promissory notes related to acquisition of subsidiaries (1)(2)	-	(14,588,298)	(2,000,000)
Purchase of certain tangible and intangible assets	-	(150,000)	(150,000)
(Increase) decrease in restricted cash and held to maturity securities	2,243,785	4,748,178	(9,809,091)
Net cash used in investing activities	(487,391)	(11,795,817)	(50,497,083)
Cash flows from financing activities:			
Proceeds from issuance of shares, net	-	3,945,736	24,361,750
Proceeds from exercise of options to employees and consultants	250	17,192	1,148,819
Proceeds from exercise of warrants	4,350,635	-	19,233,271
Repayment of convertible debentures	(5,204,167)	-	-
Proceeds from issuance of convertible debentures, net of issuance expenses	-	16,430,767	-
Long term loan received	-	-	69,638
Repayment of long term loan	(149,414)	(71,238)	(65,674)
Increase (decrease) in short term bank credit	1,455,309	1,914,892	(376,783)
Payment on capital lease obligation	-	-	(4,145)
Net cash provided by financing activities	452,613	22,237,349	44,366,876
Decrease in cash and cash equivalents	(3,659,078)	(614,094)	(6,982,403)
Cash accretion (erosion) due to exchange rate differences	(122,702)	30,234	31,790
Cash and cash equivalents at the beginning of the year	6,150,652	6,734,512	13,685,125
Cash and cash equivalents at the end of the year	\$ 2,368,872	\$ 6,150,652	\$ 6,734,512
Supplementary information on non-cash transactions:			
Issuance of shares and warrants against accrued expenses and restricted deposit	\$ -	\$ 56,577	\$ 1,310,394
Payment of principle installment of convertible debenture in shares	\$ 18,519,149	\$ 453,051	\$ -
Liability in connection to warrants granted	\$ -	\$ 44,231	\$ -
Conversion of convertible debenture to shares of common stock	\$ -	\$ -	\$ 3,837,500
Accrual for earn out in regard to subsidiary acquisition	\$ 454,350	\$ 603,764	\$ 13,435,325
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	\$ 2,018,061	\$ 1,401,681	\$ 532,750
Taxes on income	\$ 232,159	\$ 737,080	\$ 969,009

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

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

In U.S. dollars

- (1) In January 2004, the Company acquired substantially all of the outstanding ordinary shares of Epsilor Electronic Industries, Ltd. ("Epsilor"). The net fair value of the assets acquired and the liabilities assumed, at the date of acquisition, was as follows:

Working capital, excluding cash and cash equivalents	\$	(849,992)
Property and equipment		709,847
Intangible assets and goodwill		10,284,407
		10,144,262
Issuance of shares in respect to transaction costs		(12,500)
Issuance of promissory note *)		(2,940,985)
	\$	<u>7,190,777</u>

*) During 2005 and 2004 amounts of \$1,000,000 and \$2,000,000, respectively, were repaid to the former shareholders of Epsilor.

- (2) In January 2004, the Company acquired all of the outstanding common stock of FAAC Incorporated ("FAAC"). The net fair value of the assets acquired and the liabilities assumed at the date of acquisition was as follows:

Working capital, excluding cash and cash equivalents	\$	1,796,791
Property and equipment		263,669
Intangible assets and goodwill		12,072,321
		14,132,781
Issuance of shares, net		(2,003,678)
	\$	<u>12,129,103</u>

*) During 2005, an additional amount of \$13,588,298 was paid to the former shareholders of FAAC in respect of the earnout provisions of the acquisition agreement. The additional amount was charged to goodwill.

- (3) In August 2004, the Company acquired all of the outstanding common stock of Armour of America, Incorporated ("AoA"). The net fair value of the assets acquired and the liabilities assumed at the date of acquisition was as follows:

Working capital, excluding cash and cash equivalents	\$	3,219,728
Property and equipment		997,148
Intangible assets and goodwill		13,122,646
	\$	<u>17,339,522</u>

See Note 1.d. regarding additional earnout obligation to the former shareholder of AoA.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL

a. Arotech Corporation (“Arotech” or the “Company”) and its subsidiaries are engaged in the development, manufacture and marketing of defense and security products, including advanced high-tech multimedia and interactive digital solutions for training of military, law enforcement and security personnel and sophisticated lightweight materials and advanced engineering processes to armor vehicles, and in the design, development and commercialization of its proprietary zinc-air battery technology for electric vehicles and defense applications. The Company is primarily operating through IES Interactive Training, Inc. (“IES”), a wholly-owned subsidiary based in Ann Arbor, Michigan; FAAC Corporation, a wholly-owned subsidiary based in Ann Arbor, Michigan, and FAAC’s 80%-owned United Kingdom subsidiary FAAC Limited; Electric Fuel Battery Corporation, a wholly-owned subsidiary based in Auburn, Alabama; Electric Fuel Ltd. (“EFL”) a wholly-owned subsidiary based in Beit Shemesh, Israel; Epsilor Electronic Industries, Ltd., a wholly-owned subsidiary located in Dimona, Israel; MDT Protective Industries, Ltd. (“MDT”), a majority-owned subsidiary based in Lod, Israel; MDT Armor Corporation, a majority-owned subsidiary based in Auburn, Alabama; and Armour of America, Incorporated, a wholly-owned subsidiary based in Auburn, Alabama.

Revenues derived from the Company’s largest customers in 2006, 2005 and 2004 are described in Note 16.d.

b. Acquisition of Epsilor:

In January 2004, the Company entered into a stock purchase agreement between itself and all of the shareholders of Epsilor Electronic Industries, Ltd. (“Epsilor”), pursuant to the terms of which the Company purchased all of the outstanding shares of Epsilor from Epsilor’s existing shareholders. Epsilor develops and sells rechargeable and primary lithium batteries and smart chargers to the military, and to private industry in the Middle East, Europe and Asia.

The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities acquired were recorded at their estimated market values as of the date of acquisition, and results of Epsilor’s operations have been included in the consolidated financial statements commencing the date of acquisition. The total consideration of \$10,144,262 (including transaction costs) for the shares purchased consisted of (i) cash in the amount of \$7,000,000, and (ii) a series of three \$1,000,000 promissory notes, due on the first, second and third anniversaries of the agreement, which were recorded at their fair value of \$2,940,985.

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

Tangible assets acquired	\$	2,239,848
Intangible assets		
Customer list		5,092,395
Goodwill		5,192,012
Liabilities assumed		(2,379,993)
Total consideration	\$	<u>10,144,262</u>

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

Customer list in the amount of \$5,092,395 has a useful life of approximately ten years.

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

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

1. To determine the estimated market value of Epsilor's net current assets, property and equipment, and net liabilities, the "Cost Approach" was used. According to the valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.
2. The customer list is the asset that generates most of the Company's sales. Hence, the "Income Approach" was used to estimate its value, resulting in a value of \$5,092,395.

See Note 1.e. for pro forma financial information.

c. Acquisition of FAAC:

In January of 2004, the Company entered into a stock purchase agreement with the stockholders of FAAC Incorporated ("FAAC"), pursuant to the terms of which it acquired all of the issued and outstanding common stock of FAAC, a provider of driving simulators, systems engineering and software products to the United States military, government and private industry.

The Acquisition was accounted under the purchase method accounting. Accordingly, all assets and liabilities were recorded at their estimated market values as of the date acquired, and results of FAAC's operations have been included in the consolidated financial statements commencing the date of acquisition. The consideration for the purchase consisted of (i) cash in the amount of \$12.0 million, and (ii) the issuance of a total of 71,704 shares of the Company's common stock, \$0.01 par value per share, having a value of approximately \$2.0 million. There was also an earn-out based on 2004 net pretax income. Based on FAAC's 2004 net pretax income, the Company paid the former stockholders of FAAC an earnout of \$13.6 million during 2005, in cash and through the issuance of a total of 248,533 shares of the Company's common stock (see Note 13.b.4.). The total consideration of \$27.7 million (including the earn-out as well as \$137,991 of transaction costs) was determined based upon arm's-length negotiations between the Company and FAAC's stockholders.

In addition, the Company had a contingent earnout obligation in an amount equal to the net income realized by the Company from certain specific programs that were identified by the Company and the former shareholders of FAAC as appropriate targets for revenue increases in 2005. During 2005 and 2006, the Company accrued an amount of \$603,764 and \$630,000, respectively, in respect of such earnout obligation to increase FAAC's goodwill. The \$454,000 shown as promissory notes in the balance sheet is the portion of the 2006 earnout that will be paid in installments starting January 1, 2007.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

Based upon a valuation of tangible and intangible assets acquired, Arotech has allocated the total cost of the acquisition (including earnout obligation accrued as of December 31, 2006) to FAAC's assets and liabilities as follows:

Tangible assets acquired	\$	4,833,553
Intangible assets		
Technology		4,610,000
Backlog		636,000
Customer list		1,125,000
Trademarks		374,000
Goodwill		20,152,693
Liabilities assumed		(2,770,843)
Total consideration	\$	<u>28,960,403</u>

Intangible assets which are subject to amortization, excluding trademarks, which are not subject to amortization, in the amount of \$6,371,000 have a weighted-average useful life of approximately eight years.

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

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

1. To determine the estimated fair value of FAAC's net current assets, property and equipment, and net liabilities, the "Cost Approach" was used. According to the valuation made, the book values for the current assets and liabilities were reasonable proxies for their market values.
2. The amount of the cost attributable to technology of the software, documentation and know-how that drives the vehicle simulators and the high-speed missile fly-out simulators is \$4,610,000 and was determined using the "Income Approach."
3. FAAC's sales are all made on a contractual basis, most of which are over a relatively long period of time. At the date of the purchase FAAC had several signed contracts at various stages of completion. The value of the existing contracts was determined using the Income approach and resulting in a value of \$636,000.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

4. FAAC's customer list includes various branches of the U.S. military, major defense contractors, various city and country governments and others. Since customer relationships represent one of the most important revenue generating assets for FAAC, its value was estimated using the Income Approach, resulting in a value of \$1,125,000.

5. FAAC's trade name value represents the name recognition value of the FAAC brand name as a result of advertising spending by the company. The Cost Approach was used to determine the value of FAAC's trade name in the amount of \$374,000.

See Note 1.e. for pro forma financial information.

d. Acquisition of AoA:

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

The total purchase price consisted of \$19,000,000 in cash, with additional possible earn-outs if AoA is awarded certain material contracts. An additional \$3,000,000 was to be paid into an escrow account pursuant to the terms of an escrow agreement, to secure a portion of the Earnout Consideration. These funds are currently being held by the seller of AoA. Pursuant to the purchase agreement, the total consideration, sale price plus Earnout Consideration, will not be in excess of \$40,000,000. As of December 31, 2006, we had reduced the \$3.0 million escrow held by the seller of AoA by \$1,517,174 for a putative claim against such escrow in respect of such earn-out obligation. When the contingency on the earn-out provision is resolved, the additional consideration, if any, will be recorded as additional purchase price. The purchase price also included \$131,177 of transaction costs. The transaction has been accounted for using the purchase method of accounting, and accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based upon their fair values at the date the acquisition was completed.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

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

Tangible assets acquired	6,346,316
Intangible assets	
Certifications	246,969
Backlog	1,512,000
Customer relationships	490,000
Tradenname /Trademark	70,000
Covenants not to compete	260,000
Goodwill	11,757,812
Liabilities assumed	(347,770)
Total consideration	<u>\$ 20,335,327</u>

Intangible assets, excluding trademarks, which are not subject to amortization, in the amount of \$2,508,969 have a weighted-average useful life of approximately two years.

In connection with the Company's acquisition of AoA, the Company has a contingent earnout obligation in an amount equal to the revenues realized by the Company from certain specific programs that were identified by the Company and the former shareholder of AoA as appropriate targets for revenue increases. The earnout provides that if AoA receives certain types of orders from certain specific customers prior to December 31, 2006 ("Additional Orders"), then upon shipment of goods in connection with such Additional Orders, the former shareholder of AoA will be paid an earnout based on revenues, up to a maximum of an additional \$6.0 million. As of December 31, 2006, we had reduced the \$3.0 million escrow held by the seller of AoA by \$1,517,174 for a putative claim against such escrow in respect of such earn-out obligation.

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

See Note 1.f. for impairment information.

See Note 1.e. for pro forma financial information.

e. Pro forma results

In January 2004, the Company acquired FAAC and Epsilor, as more fully described in "Note 1.b. - Acquisition of Epsilor" and "Note 1.c. - Acquisition of FAAC," above, in August 2004, the Company acquired AoA, as more fully described in "Note 1.d. - Acquisition of AoA," above (the "Acquisitions"). The following summary pro forma information includes the effects of the Acquisitions on the operating results of the Company. The following unaudited pro forma data for 2004 is presented as if the Acquisition had been completed on January 1, 2004.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

This pro forma financial information does not purport to be indicative of the results of operations that would have occurred had the Acquisitions taken place at the beginning of the period, nor do they purport to be indicative of the results of operations that will be obtained in the future.

	2004 (Unaudited)
Total revenues	\$ 61,086,697
Gross profit	22,528,254
Net loss	(5,810,114)
Deemed dividend of common stock attributable to certain stockholders	(3,328,952)
Net loss attributable to stockholders of common stock	\$ (9,139,066)
Basic and diluted net loss per share	\$ (1.83)
Weighted average number of shares used in computing basic net loss per share	4,995,218

f. Impairment of goodwill and other intangible assets:

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement, at least annually thereafter, and between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. 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, weighted average cost of capital and estimates of market multiples for the reportable units.

During 2005, the Company performed impairment test of goodwill, based on management's projections and using expected future discounted operating cash flows and as response to several factors, including without limitation the reduced sales in AoA (a component of the Company's Armor Division) the fact that AoA failed to meet its projections, the decision of the General Manager of AoA and his new supervisor to leave the employ of AoA and the Company, respectively, and general uncertainty about the market for AoA's products in general and AoA's business in particular; specifically, the delay or loss of several potential orders, decisions by customers to utilize methods of armor not produced by AoA (hard armor instead of soft armor), the change in U.S. military priorities from acquiring new armor to funding the ground forces in Iraq and Afghanistan. Furthermore, following Hurricane Katrina, substantial funds earmarked for defense were delayed to provide funds for hurricane relief. As of December 31, 2005, as a result of this impairment test, the Company identified in AoA an impairment of goodwill in the amount of \$11,757,812.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

In 2006, the company identified an additional \$316,024 in potential earn-out obligations in an amount equal to the revenues realized by the Company from certain specific programs at AoA. This expense is shown as impairment expense since the full amount of AoA goodwill had been previously written off in 2005.

See Note 1.e. for earn-out information

The Company and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2004 the Company identified an impairment of the technology previously purchased from Bristlecone and as a result has recorded an impairment loss in the amount of \$320,279. As of December 31, 2005 the Company identified an impairment of backlog, trademarks and a covenant not to compete previously identified with respect to the AoA acquisition and as a result recorded an impairment loss in the amount of \$498,944.

g. Reverse stock split:

On June 20, 2006, Arotech Corporation filed a Certificate of Amendment with the Delaware Secretary of State which served to effect, as of 7:00 a.m. e.d.t. on June 21, 2006, a one-for-fourteen reverse split of Arotech's common stock. As a result of the reverse stock split, every fourteen shares of Arotech common stock were combined into one share of common stock; any fractional shares created by the reverse stock split were eliminated. The par value of the shares remained unchanged. The reverse stock split affected all of Arotech's common stock, stock options, warrants and convertible debt outstanding immediately prior to the effective date of the reverse stock split. The reverse split reduced the number of shares of Arotech's common stock outstanding at June 21, 2006 from 118,587,361 shares to 8,468,957 shares. All references to common share and per common share amounts for all periods presented have been retroactively restated to reflect this reverse split, except for common stock amounts in the 2005 Consolidated Balance Sheet and 2004 and 2005 Statements of Changes in Stockholder Equity.

h. Related parties

The Company has a consulting agreement with Sampen Corporation that it executed in March 2005, effective as of January 1, 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 as extended expires on December 31, 2008, and is extended automatically for additional terms of two years each unless either Sampen or the Company terminate the agreement sooner.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 1:- GENERAL (Cont.)

Pursuant to the terms of our agreement with Sampen, Sampen provides one of its employees to the Company for such employee to serve as the Company's Chief Operating Officer. The Company pays Sampen \$12,800 per month, plus an annual bonus, on a sliding scale, in an amount equal to a minimum of 20% of Sampen's annual base compensation then in effect, up to a maximum of 75% of its annual base compensation then in effect if the results the Company actually attains for the year in question are 120% or more of the amount we 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, 2006, 2005 and 2004, the Company paid Sampen a total of \$208,896, \$208,896 and \$318,100, respectively.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

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

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

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Restricted collateral deposits

Restricted cash is primarily invested in highly liquid deposits which are used as a security for the Company's guarantee performance, its liability to a former shareholder of its acquired subsidiary and for the company's liability for interest payments related to its convertible debentures.

f. Marketable securities

The Company and its subsidiaries account for investments in debt and equity securities in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). Management 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.

At December 31, 2006 the Company and its subsidiaries classified its investment in marketable securities as available-for-sale.

Investment in trust funds are classified as available-for-sale and stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of income.

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 2006 2005 and 2004, the Company wrote off \$292,864, \$1,062,336 and \$121,322 of obsolete inventory respectively, which has been included in the cost of revenues.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Cost is determined as follows:

Raw and packaging materials - by the average cost method.

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

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

h. Property and equipment:

Property and equipment are stated at cost net of accumulated depreciation and investment grants received from the State of Israel for investments in fixed assets under the Investment Law (no investment grants were received during 2006, 2005 and 2004).

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

	%
Computers and related equipment	33
Motor vehicles	15
Office furniture and equipment	6 - 10
Machinery and equipment	10 - 25 (mainly 10)
Leasehold improvements	By the shorter of the term of the lease or the life of the asset

i. Goodwill:

Goodwill represents the excess of cost over the fair value of the net assets of businesses acquired. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142") goodwill acquired in a business combination on or after July 1, 2001, is not amortized after January 1, 2002.

SFAS No. 142 requires goodwill to be tested for impairment on adoption of the Statement and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the Company's reportable units with their carrying value. Fair value is determined using discounted cash flows. 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.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

See Note 1.f. regarding the impairment test.

j. Long-lived assets:

Intangible assets acquired in a business combination that are subject to amortization are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 144.

The acquired trademarks and tradenames are deemed to have an indefinite useful life because they are expected to contribute to cash flows indefinitely. Therefore, the trademarks will not be amortized until their useful life is no longer indefinite. The trademarks and tradenames are tested annually for impairment in accordance FAS 142.

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

See Note 1.f. regarding the impairment test.

k. Revenue recognition:

The Company is a defense and security products and services company, engaged in three business areas: interactive simulation for military, law enforcement and commercial markets; batteries and charging systems for the military; and high-level armoring for military, paramilitary and commercial vehicles. During 2006, the Company and its subsidiaries recognized revenues as follows: (i) from the sale and customization of interactive training systems and from the maintenance services in connection with such systems (Simulation and Training Division); (ii) from revenues under armor contracts and for service and repair of armored vehicles (Armor Division); (iii) from the sale of batteries, chargers and adapters to the military, and under certain development contracts with the U.S. Army (Battery and Power Systems Division); and (iv) from the sale of lifejacket lights (Battery and Power Systems Division).

Revenues from the Battery and Power Systems Division products and Armor Division are recognized in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" when persuasive evidence of an agreement exists, delivery has occurred, the fee is fixed or determinable, collectability is probable, and no further obligation remains.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues from contracts that involve customization of FAAC's simulation system to customer specific specifications are recognized in accordance with Statement Of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," 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 incurred to date in the project compared to 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. 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. As of December 31, 2006, \$741,165 in estimated losses were identified and expensed during the period.

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, which do not require significant customization, are recognized in accordance with Statement of Position 97-2, "Software Revenue Recognition," ("SOP 97-2"). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has adopted Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions" ("SOP 98-9"). According to SOP No. 98-9, revenues are allocated to the different elements in the arrangement under the "residual method" when Vendor Specific Objective Evidence ("VSOE") of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the residual method, at the outset of the arrangement with the customer, the Company defers revenue for the fair value of its undelivered elements (maintenance and support) and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (software product) when all other criteria in SOP 97-2 have been met.

Revenue from such simulators is 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 collectibility 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 VSOE of fair value of the maintenance, training and support services is determined based on the price charged when sold separately or when renewed.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

l. Right of return:

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

m. Warranty:

The Company offers up to one year warranty for most of its products. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the Company does business. The Company estimates the costs that may be incurred under its basic limited warranty, including parts and labor. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs as the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. As of December 31, 2006, warranty liability was not material.

n. Research and development cost:

SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires capitalization of 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, when applicable. 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 the: (i) ratio that current gross revenues from sales of the software bears to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (two to five years). The Company assesses the net realizable value of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2006.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

o. Income taxes:

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

p. Concentrations of credit risk:

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

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

The Company's available for sale marketable securities and held-to-maturity securities include investments in debentures of U.S. and Israeli corporations and state and local governments. Management believes that those corporations and states are institutions that are financially sound, that the portfolio is well diversified, and accordingly, that minimal credit risk exists with respect to these marketable securities.

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

q. Basic and diluted net loss per share:

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

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

All outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options, restricted stock and warrants excluded from the calculations of diluted net loss per share was 1,781,984, 2,563,918 and 2,250,154 for the years ended December 31, 2006, 2005 and 2004, respectively.

r. Accounting for stock-based compensation

Effective January 1, 2006, the Company started to account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R) ("SFAS No. 123(R)"), "Share-Based Payment," using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. The Company determines the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values. The adoption of SFAS No. 123(R) resulted in a reduction in income of \$500,545 in 2006 which reduced basic and diluted EPS for the year by \$0.06.

In 2005 and prior, the Company had elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB No. 25") and Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. Under APB No. 25, , no compensation expense was recognized if at the date of grant, the exercise price of the stock option was at least equal to the per share fair value of the underlying stock .

The fair value for the options to employees was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions: risk-free interest rates of 4.64%, 4.28% and 3.63% for 2006, 2005 and 2004, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the common stock of 1.33 for 2006, 0.76 for 2005 and 0.81 for 2004; and a weighted-average expected life of the option of three years for 2006, three years for 2005 and five years for 2004. The company assumed a zero forfeiture rate.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The following table illustrates the effect on net income and earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS No. 123 in 2005 and 2004 on its stock-based employee compensation:

	December 31,	
	2005	2004
Net loss as reported	\$ (24,043,411)	\$ (9,042,313)
Add: Stock-based compensation expenses included in reported net loss	674,712	831,626
Deduct: Stock-based compensation expenses determined under fair value method for all awards	(2,461,787)	(2,741,463)
	<u><u>\$ (25,830,486)</u></u>	<u><u>\$ (10,952,150)</u></u>
Loss per share:		
Basic and diluted, as reported	<u><u>\$ (4.09)</u></u>	<u><u>\$ (2.48)</u></u>
Diluted, pro forma	<u><u>\$ (4.40)</u></u>	<u><u>\$ (2.19)</u></u>

s. Fair value of financial instruments:

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

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

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

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

t. Severance pay:

The Company's liability for severance pay is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. 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 employees is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual, in accordance with EITF 88-1: "Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan." The value of these policies is recorded as an asset in the Company's balance sheet.

In addition and according to certain employment agreements, the Company is obligated to provide for a special severance pay in addition to amounts due to certain employees pursuant to Israeli severance pay law. The Company has made a provision for this special severance pay over the service life of the employee. As of December 31, 2006 and 2005, the accumulated severance pay in that regard amounted to \$2,163,264 and \$1,732,955, respectively.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Pursuant to the terms of the employment agreement between the Company and its Chief Executive Officer, funds to secure payment of the Chief Executive Officer's contractual severance are to be deposited for the benefit of the Chief Executive Officer, with payments to be made pursuant to an agreed-upon schedule. As of December 31, 2006, a total of \$617,240 had been deposited. These funds continue to be owned by the Company, which benefits from all gains and bears the risk of all losses resulting from investments of these funds.

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

Severance expenses for the years ended December 31, 2006, 2005 and 2004 amounted to \$563,302, \$639,952 and \$460,178, respectively.

u. Advertising costs:

The Company and its subsidiaries expense advertising costs as incurred. Advertising expense for the years ended December 31, 2006, 2005 and 2004 was approximately \$21,000, \$150,000 and \$13,000, respectively.

v. New accounting pronouncements:

In May 2005, the FASB issued Statement of Financial Accounting Standard No. 154 ("FAS No. 154"), "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20, "Accounting Changes," and FAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." FAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. FAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. FAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of FAS No. 154 did not have a material effect on the Company's financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments" ("SFAS No. 155"), which amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133") and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS No. 140"). SFAS No. 155 provides guidance to simplify the accounting for certain hybrid instruments by permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative, as well as clarifying that beneficial interests in securitized financial assets are subject to SFAS 133. In addition, SFAS No. 155 eliminates a restriction on the passive derivative instruments that a qualifying special-purpose entity may hold under SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a new basis occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company believes that the adoption of this statement will not have a material effect on its financial condition or results of operations.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets" ("SFAS No. 156"), which amends SFAS No. 140. SFAS No. 156 provides guidance addressing the recognition and measurement of separately recognized servicing assets and liabilities, common with mortgage securitization activities, and provides an approach to simplify efforts to obtain hedge accounting treatment. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity's fiscal year that begins after September 15, 2006, with early adoption being permitted. The Company believes that the adoption of this statement will not have a material effect on its financial condition or results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," which clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with FAS 109, "Accounting for Income Taxes." The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company is required to adopt the provisions of the Interpretation effective January 1, 2007. The Company has not yet completed its assessment of the affect of adoption of the Interpretation on the Company's financial statements.

In September 2006, the SEC issued SAB 108. SAB 108 provides guidance on the consideration of effects of the prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SEC staff believes registrants must quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the first annual period ending after November 15, 2006 with early application encouraged. The adoption of this statement at December 31, 2006 did not have a material effect on the Company's financial condition or results of operations

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which establishes a common definition for "fair value" to be applied to generally accepted accounting principles in the United States. It provides guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 157 on the Company's financial statements.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," which requires that employers recognize, on a prospective basis, the funded status of their defined benefit pension and other postretirement plans on their consolidated balance sheet and recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost. SFAS No. 158 also requires additional disclosures in the notes to financial statements. SFAS No.158 is effective as of the end of fiscal years ending after December 15, 2006. The adoption of this statement at December 31, 2006 did not have a material effect on the Company's financial condition or results of operations

w. Reclassification:

Certain prior period amounts have been reclassified to conform to the current period presentation.

NOTE 3:- RESTRICTED COLLATERAL DEPOSITS

	December 31,	
	2006	2005
Short-term:		
AoA earnout (Note 1.d.)	\$ -	\$ 1,795,850
Deposits in connection with FAAC projects	535,151	548,973
Restricted cash in connection with interest payment to convertible debenture holders.	113,824	1,395,079
Other	-	157,211
Total short-term	648,975	3,897,113
Long-term:		
Restricted cash in connection with interest payment to convertible debenture holders.	-	779,286
Total long-term	-	779,286
	<u>\$ 648,975</u>	<u>\$ 4,676,399</u>

NOTE 4: - AVAILABLE FOR SALE MARKETABLE SECURITIES

The following is a summary of investments in marketable securities as of December 31, 2006 and 2005:

	Cost		Unrealized gains		Estimated fair value	
	2006	2005	2006	2005	2006	2005
Available for sale marketable securities	\$ 36,708	\$ 32,558	\$ 4,458	\$ 3,426	\$ 41,166	\$ 35,984

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
In U.S. dollars
NOTE 5:- OTHER ACCOUNTS RECEIVABLE (INCLUDING LONG TERM) AND PREPAID EXPENSES

	December 31,	
	2006	2005
Government authorities	\$ 213,362	\$ 460,265
Employees	77,836	65,735
Prepaid expenses	292,496	1,360,589
Deferred taxes	58,032	64,820
Long term receivables	262,608	-
Other	492,896	312,922
	<u>\$ 1,397,230</u>	<u>\$ 2,264,331</u>

NOTE 6:- INVENTORIES

	December 31,	
	2006	2005
Raw and packaging materials	\$ 4,556,250	\$ 3,296,453
Work in progress	3,186,843	3,697,361
Finished products	108,727	821,992
	<u>\$ 7,851,820</u>	<u>\$ 7,815,806</u>

NOTE 7:- PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment is as follows:

	December 31,	
	2006	2005
Cost:		
Computers and related equipment	\$ 2,080,462	\$ 3,081,029
Motor vehicles	674,737	704,718
Office furniture and equipment	1,015,054	786,958
Machinery, equipment and installations	4,108,763	7,716,598
Leasehold improvements	887,311	1,399,683
Demo inventory	643,458	369,995
	<u>\$ 9,409,785</u>	<u>\$ 14,058,981</u>
Accumulated depreciation:		
Computers and related equipment	1,626,066	2,328,549
Motor vehicles	234,023	233,745
Office furniture and equipment	585,069	474,127

Machinery, equipment and installations	2,466,598	5,729,563
Leasehold improvements	385,196	974,666
Demo inventory	372,240	65,400

	5,669,192	9,806,050

Depreciated cost	\$ 3,740,593	\$ 4,252,931

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

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

b. Depreciation expense amounted to \$1,966,748, \$1,308,180 and \$1,199,465 for the years ended December 31, 2006, 2005 and 2004, respectively.

As for liens, see Note 11.d.

NOTE 8:- GOODWILL AND OTHER INTANGIBLE ASSETS, NET

a. Goodwill

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

	12/31/05	Additions	Adjustments (currency)	12/31/06
Simulation	\$ 23,605,069	\$ 630,350	\$ -	\$ 24,235,419
Battery	4,968,676	-	444,534	5,413,210
Armor	985,412	-	81,184	1,066,596
Total	\$ 29,559,157	\$ 630,350	\$ 525,718	\$ 30,715,225

b. Other intangible assets

	Year ended December 31,	
	2006	2005
Cost:		
Technology	\$ 6,405,000	\$ 6,841,746
Capitalized software costs	1,701,150	1,226,579
Backlog	682,000	2,194,000
Covenants not to compete	99,000	359,000
Customer list	7,548,645	7,548,645
Certification	246,969	246,969
	16,682,764	18,416,939
Exchange differences	175,958	(171,587)
Less - accumulated amortization	(8,155,508)	(7,267,630)
Less - impairment	-	(819,223)
	8,703,214	10,158,499
Amortized cost	799,000	869,000
Trademarks		
	\$ 9,502,214	\$ 11,027,499

Amortization and impairment expenses amounted to \$2,857,891, \$3,695,772 and \$2,888,226 for the years ended December 31, 2006, 2005 and 2004, respectively.

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

c. Estimated amortization expenses, except capitalized software costs, for the years ended

	Year ended December 31,	
2007		\$ 1,277,522
2008		1,277,522
2009		1,274,722
2010		1,107,723
2011		1,085,490
2012 and forward		1,018,478
		<u>\$ 7,041,457</u>

NOTE 9:- SHORT-TERM BANK CREDIT AND LOANS

The Company and/or certain of its subsidiaries has \$6.5 million authorized in credit lines from certain banks, of which \$478,057 is denominated in NIS and carries an interest rate of approximately prime + 1.87% and 6 million is denominated in dollars and carries an interest rate of prime + 0.25%. As of December 31, 2006, \$5.4 million was utilized, out of which \$2.0 million is related to letter of credit issued to one of the customers of one of the Company's subsidiaries.

These lines of credit are secured by the accounts receivable, inventory and marketable securities of the relevant subsidiary of the Company.

In 2005, the Company had a \$5.2 million authorized credit line from certain banks, of which \$206,000 was denominated in NIS and carries an interest rate of approximately prime + 2.8% and \$ 5.0 million of which was denominated in dollars and carries an interest rate of prime + 0.25%. As of December 31, 2005, \$4.0 million was utilized, out of which \$2.0 million was related to a letter of credit issued to one of the customers of one of the Company's subsidiaries.

This line of credit was secured by the accounts receivable, inventory and marketable securities of the relevant subsidiary of the Company.

NOTE 10:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2006	2005
Employees and payroll accruals	\$ 1,288,601	\$ 1,443,154
Accrual for expected loss	829,973	485,877
Accrued vacation pay	442,068	504,342
Accrued expenses	1,380,150	1,788,558
Minority balance	-	172,871
Government authorities	815,374	439,975
Advances from customers	414,889	795,331
	<u>\$ 5,171,055</u>	<u>\$ 5,630,108</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments:

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

Royalties paid or accrued for the years ended December 31, 2006, 2005 and 2004 to the OCS amounted to \$30,402, \$28,502 and \$17,406, respectively.

As of December 31, 2006, the total contingent liability to the OCS was approximately \$10,370,175. The Company regards the probability of this contingency coming to pass in any material amount to be low.

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

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

No royalties were paid or accrued to the BIRD-F in each of the three years in the period ended December 31, 2006.

As of December 31, 2006, the total contingent liability to pay BIRD-F (150%) was approximately \$772,000. The Company regards the probability of this contingency coming to pass in any material amount to be low.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

b. Lease commitments:

The Company and its subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2009. The minimum rental payments under non-cancelable operating leases are as follows:

	Year ended December 31
2007	\$ 621,678
2008	\$ 68,750
2009	\$ 82,500

Total rent expenses for the years ended December 31, 2006, 2005 and 2004 were \$878,908, \$1,022,396 and \$868,900 respectively.

The Company also signed three capital leases during 2006 with an aggregate value of approximately \$250,000. These leases have terms from 3 to 5 years and are for equipment purchases. The equipment is classified under machinery and equipment in fixed assets.

The table below details the original value, depreciation and net book value of the leased assets. The net book value is included the property and equipment totals in the balance sheet.

Leased Assets	12/31/2006
Equipment	\$ 249,532
Less: Accumulated Depreciation	20,130
Net book value	\$ 229,402

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

Liabilities	
Obligations under capital leases	12/31/2006
Current	\$ 55,263
Noncurrent	158,120
Total	\$ 213,383

The table below details the minimum future lease payments due along with the present value of the net minimum lease payments as of December 31, 2006.

Future Minimum Lease Payments	Year ended December 31
2007	\$ 79,623
2008	83,710
2009	55,101
2010	34,667
2011	16,655
Total minimum lease payments	269,756

Less: Amount representing interest		56,373
Present value of minimum lease payments	\$	213,383

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

c. Guarantees:

The Company obtained bank guarantees in the amount of \$885,551 in connection (i) obligations of two of the Company's subsidiaries to the Israeli customs authorities and, (ii) obligation of one of the Company's subsidiaries to secure the return of products loaned to the Company from one of its customers and (iii) obligation of the Company to secure payment on a senior debt, and (iv) obligation of one of the Company's subsidiaries to secure a required letter of credit required under a long term contract.. In addition, the Company has two outstanding letters of credit in the amounts of \$1,947,854 and \$60,000 to two of its subsidiary's customers.

The Company's active United States subsidiaries act as guarantors of the Company's obligations under its senior secured convertible notes.

d. Liens:

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

The Company has granted to the holders of its senior secured convertible notes (i) a second position security interest in the assets and receivables of FAAC Incorporated, and in the receivables of MDT Armor Corporation related to MDT's David order with the U.S. Army (junior to the security interest of a bank that extends to FAAC Corporation a \$6.0 million line of credit) and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries and in the stock of all of the Company's active United States subsidiaries, as well as in any stock that the Company acquires in future Acquisitions (as defined in the securities purchase agreement).

FAAC has a \$6.0 million line of credit secured by the assets and receivables of FAAC and by the receivables of MDT Armor Corporation related to MDT's David order with the U.S. Army.

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

e. Litigation and other claims:

As of December 31, 2006, there were no pending material legal proceedings to which the Company was a party, other than ordinary routine litigation incidental to its business, except as follows:

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

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

1. In December 2004, AoA filed an action against a U.S. government defense agency, seeking approximately \$2.2 million in damages for alleged improper termination of a contract. In its answer, the government agency counterclaimed, seeking approximately \$2.1 million in procurement expenses. AoA is preparing its answer to the counterclaim. At this stage in the proceedings, the Company and its legal advisors cannot determine with any certainty whether AoA will have any liability and, if so, the extent of that liability.

NOTE 12:- CONVERTIBLE DEBT AND DETACHABLE WARRANTS

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

Pursuant to the terms of a Securities Purchase Agreement dated December 31, 2002, the Company issued and sold to a group of institutional investors an aggregate principal amount of 9% secured convertible debentures in the amount of \$3.5 million due June 30, 2005. These debentures are convertible at any time prior to June 30, 2005 at a conversion price of \$10.50 per share, or a maximum aggregate of 333,333 shares of common stock. The conversion price of these debentures was adjusted to \$8.96 per share in April 2003. In accordance with EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," the terms of convertible debentures were not treated as changed or modified when the cash flow effect on a present value basis was less than 10%.

As part of the securities purchase agreement on December 31, 2002, the Company issued to the purchasers of its 9% secured convertible debentures due June 30, 2005, warrants, as follows: (i) Series A Warrants to purchase an aggregate of 83,336 shares of common stock at any time prior to December 31, 2007 at a price of \$11.76 per share; (ii) Series B Warrants to purchase an aggregate of 83,336 shares of common stock at any time prior to December 31, 2007 at a price of \$12.46 per share; and (iii) Series C Warrants to purchase an aggregate of 83,336 shares of common stock at any time prior to December 31, 2007 at a price of \$13.02 per share. The exercise price of these warrants was adjusted to \$8.96 per share in April 2003.

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

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

During 2004, the remaining principal amount of \$1,150,000 of 9% secured convertible debentures outstanding was converted into an aggregate of 128,348 shares of common stock.

During 2004, the Company recorded expenses of \$372,600 attributable to amortization due to conversion of the convertible debenture into shares.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBT AND DETACHABLE WARRANTS (Cont.)

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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$5.0 million due September 30, 2006. These debentures were convertible at any time prior to September 30, 2006 at a conversion price of \$16.10 per share, or a maximum aggregate of 310,559 shares of common stock.

As part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 89,286 shares of common stock at any time prior to September 30, 2006 at a price of \$20.125 per share. In March 2006, 8,929 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 3,571 shares at an exercise price of \$8.316. As a result of this repricing of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$24,531.

This transaction was accounted according to APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments." The fair value of these warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 1.95%, a volatility factor 98%, dividend yields of 0% and a contractual life of three years.

In connection with these convertible debentures, the Company recorded a deferred debt discount of \$2,963,043 with respect to the beneficial conversion feature and the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - or to the actual conversion date, if earlier, as financial expenses.

During 2004, an aggregate of principal amount \$1,075,000 in 8% secured convertible debentures was converted into an aggregate of 66,770 shares.

During 2004 and 2005, the Company recorded expenses of \$613,263 and \$29,603, respectively, of which \$191,895 and \$29,603, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$421,368 and \$0, respectively, was attributable to amortization due to conversion of the convertible debenture into shares. During 2006, the Company recorded an expense of \$22,142, which was attributable to amortization of debt discount and beneficial conversion feature related to the convertible debenture over its term. These expenses were included in the financial expenses.

During 2006, the Company paid the remaining principal amount of \$150,000 in respect of these secured convertible debentures.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBT AND DETACHABLE WARRANTS (Cont.)

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

Pursuant to the terms of a Securities Purchase Agreement dated September 30, 2003, the Company issued and sold to a group of institutional investors an aggregate principal amount of 8% secured convertible debentures in the amount of \$6.0 million due September 30, 2006. These debentures were convertible at any time prior to September 30, 2006 at a conversion price of \$20.30 per share, or a maximum aggregate of 295,567 shares of common stock.

As a further part of the securities purchase agreement on September 30, 2003, the Company issued to the purchasers of its 8% secured convertible debentures due September 30, 2006, warrants to purchase an aggregate of 107,143 shares of common stock at any time prior to December 18, 2006 at a price of \$25.375 per share. Additionally, the Company issued to the investors supplemental warrants to purchase an aggregate of 74,143 shares of common stock at any time prior to December 31, 2006 at a price of \$30.80 per share. In February and March 2006, an aggregate of 55,607 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holders of these warrants received new warrants to purchase an aggregate of 22,244 shares at an exercise price of \$8.316. In April 2006, 11,121 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 4,449 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$39,221.

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

In connection with these convertible debentures, the Company recorded a deferred debt discount of \$6,000,000 with respect to the beneficial conversion feature and the discount arising from fair value allocation to warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - September 30, 2006 - or to the actual conversion date, if earlier, as financial expenses.

During 2004 an aggregate of 107,143 shares were issued pursuant to exercise of these warrants. Out of these warrants, the holders of 80,357 warrants exercised their warrants on July 14, 2004 were granted an additional warrants to purchase 80,357 shares of common stock of the Company at an exercise price per share of \$19.32. See also Note 13.d.3.

During 2004 and 2005, the Company recorded expenses of \$3,156,246 and \$1,562,378, respectively, of which \$1,782,561 and \$1,562,378, respectively, was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term and \$1,373,685 and \$0, respectively, was attributable to amortization due to conversion of the convertible debenture into shares. During 2006, the Company recorded an expense of \$1,168,573, which was attributable to amortization of the beneficial conversion feature of the convertible debenture over its term. These expenses were included in the financial expenses.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBT AND DETACHABLE WARRANTS (Cont.)

During 2006, the Company paid in cash the remaining principal amount of \$4,387,500 in respect of these secured convertible debentures.

d. Senior Secured Convertible Notes due March 31, 2008

Pursuant to the terms of a Securities Purchase Agreement dated September 29, 2005 (the "Purchase Agreement") by and between the Company and certain institutional investors, the Company issued and sold to the investors an aggregate of \$17.5 million principal amount of senior secured notes having a final maturity date of March 31, 2008.

Under the terms of the Purchase Agreement, as amended, the Company granted the investors (i) a second position security interest in the assets and receivables of FAAC Incorporated, and in the receivables of MDT Armor Corporation related to MDT's David order with the U.S. Army (junior to the security interest of a bank that extends to FAAC Corporation a \$6.0 million line of credit) and (ii) a first position security interest in the assets of all of the Company's other active United States subsidiaries and in the stock of all of the Company's active United States subsidiaries, as well as in any stock that the Company acquires in future Acquisitions (as defined in the securities purchase agreement). The Company's active United States subsidiaries are also acting as guarantors of the Company's obligations under the Notes.

The Notes are convertible at the investors' option at a fixed conversion price of \$14.00. The Notes bear interest at a rate equal to six month LIBOR plus 6% per annum, subject to a floor of 10% and a cap of 12.5%. The Company will repay the principal amount of the Notes over a period of two and one-half years, with the principal amount being amortized in twelve payments payable at the Company's option in cash and/or stock, provided certain conditions are met. In the event the Company elects to make such payments in stock, the price used to determine the number of shares to be issued will be calculated using an 8% discount to the average trading price of the Company's common stock during 17 of the 20 consecutive trading days ending two days before the payment date.

As a further part of the Securities Purchase Agreement dated September 29, 2005, the Company issued warrants, which are not exercisable for the six month period following closing, to purchase up to 375,000 shares of common stock (30% warrant coverage) at an exercise price of \$15.40 per share. These warrants were exercisable until March 29, 2007.

This transaction was accounted according to APB No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" and Emerging Issue Task Force No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF 00-27"). The fair value of the warrants granted in respect of convertible debentures was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.87%, a volatility factor 53%, dividend yields of 0% and a contractual life of one year.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBT AND DETACHABLE WARRANTS (Cont.)

In connection with these convertible notes, the Company recorded a deferred debt discount of \$422,034 with respect to the discount arising from fair value allocation of the warrants according to APB No. 14, which is being amortized from the date of issuance to the stated redemption date - March 31, 2008 - or the actual conversion date, if earlier, as financial expenses

The Company has also considered EITF No. 05-2, "The Meaning of Conventional Convertible Debt Instrument" in EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." Accordingly, the Company has concluded that these convertible notes would be considered as conventional convertible debt.

As to EITF No. 00-19, since the terms of the warrants referred to above provided that upon exercise of a warrant the Company could issue only stock that had been registered with the SEC (which occurred in December 2005) and therefore freely tradable, in accordance with Emerging Issues Task Force No 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. The fair value of these warrants was remeasured as at December 31, 2005 using the Black-Scholes pricing model assuming a risk free interest rate of 3.87%, a volatility factor of 64%, dividend yields of 0% and a contractual life of approximately nine months. The change in the fair value of the warrants between the date of the grant and December 31, 2005 in the amount of \$377,803 has been recorded as finance income.

During 2005 and 2006, the Company recorded expenses of \$110,771 and \$293,795 respectively, attributable to amortization of the deferred debt discount arising from the fair value allocation of the warrants.

The Notes provide for repayment in twelve equal installments. Installments may be paid in cash or, at the Company's option (subject to certain conditions), in stock. If the Company elects to make a payment in stock, it must give notice 24 trading days prior to the date the installment is due, and issue shares of its stock to the holders of the Note based on a conversion price of \$14.00. Thereafter, based on a price of 92% of the average price of the stock during 17 of the trading days between the notice date and the installment payment date, the Company issues additional shares based on the amount, if any, by which the average price of the stock was less than \$14.00. In respect of scheduled payments of Note principal, the Company issued 82,976 shares in 2005 and 444,005 shares in the first three months of 2006.

On April 7, 2006, the Company and each investor entered into conversion agreements dated April 7, 2006 (collectively, the "Conversion Agreements") pursuant to which an aggregate of \$6,148,904 principal amount of the Notes was converted into 1,098,019 shares of the Company's common stock. The amount converted eliminated the Company's obligation to make the installment payments under the Notes on each of March 31, 2008, January 31, 2008, November 30, 2007 and September 30, 2007 (aggregating a total of \$5,833,333). In addition, as a result of the conversion an additional \$315,570 was applied against part of the installment payment due July 31, 2007. After giving effect to the conversion, \$8,434,430 of principal remained outstanding under the Notes. Each Investor also agreed, among other things, to defer the installment payment due on May 31, 2006 to July 31, 2006 or, in certain circumstances, August 31, 2006. This transaction was accounted for under SFAS No. 84, "Induced Conversions of Convertible Debt." Accordingly, a loss of approximately \$4.9 million was recognized on this transaction and included in financial expense.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 12:- CONVERTIBLE DEBT AND DETACHABLE WARRANTS (Cont.)

During the remainder of 2006, in respect of scheduled payments of Note principal, the Company issued a total of 2,642,833 shares to pay \$5,833,333 in debt. Total loss charged to financial expense in 2006 for stock principal redemption approximated \$507,000. At December 31, 2006, the remaining principal balance of the Notes was \$2.6 million.

e. The Company's debt agreements contain customary affirmative and negative operations covenants that limit the discretion of its management with respect to certain business matters and place restrictions on it, including obligations on the Company's part to preserve and maintain assets and restrictions on its ability to incur or guarantee debt, to merge with or sell its assets to another company, and to make significant capital expenditures without the consent of the debenture holders, as well as granting to the Company's investors a right of first refusal on any future financings, except for underwritten public offerings in excess of \$30 million. Management does not believe that this right of first refusal will materially limit the Company's ability to undertake future financings.

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. Issuance of common stock to investors and in respect of acquisitions:

1. In January 2004, the Company issued an aggregate of 702,888 shares of common stock at a price of \$26.32 per share, or a total purchase price of \$18,500,000, to several institutional investors. (see also Note 13.d.2.). Finance expenses in connection with this issuance totaled \$692,500.

2. In July 2004, pursuant to a Securities Purchase Agreement dated July 15, 2004, the Company issued an aggregate of 304,148 shares of common stock at a price of \$21.70 per share, or a total purchase price of \$6,600,000, to a group of investors (see also Note 13.d.3.).

3. In May 2005, the Company issued an aggregate of 91,107 shares of common stock at a price of \$14.00 per share, or a total purchase price of \$1,275,500, to several institutional investors.

4. In connection with the satisfaction by the Company of the provision of the FAAC purchase agreement related to an earn-out based on 2004 net pretax income, the Company, in May 2005, issued to the former shareholders of FAAC a total of 248,533 shares, which together with cash paid by the Company to the former shareholders of FAAC, was sufficient to satisfy the Company's obligation in respect of this earn-out provision.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

c. Issuance of common stock to service providers and employees and as donations to charities

1. Beginning in January 2004, the Company entered into a consulting agreement with one of its directors pursuant to which the director agreed to aid the Company in identifying potential acquisition candidates, in exchange for a commission. The Company also agreed to issue to this director, at par value, a total of 2,286 shares of its common stock, the value of which was to be deducted from any transaction fees paid. 1,143 of these shares were earned and issued prior to termination of this agreement in August 2004. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to \$28,160 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company recorded this compensation expense of \$28,160 during 2004 and included this amount in general and administrative expenses

2. In February 2004, the Company issued 5,301 shares of common stock to a consultant as commissions on battery orders. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to \$171,680 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company accrued this compensation expense of \$171,680 during 2003 and included this amount in selling and marketing expenses.

3. In June 2004 the Company sold 2,857 shares of the Company's common stock at a price of \$14.00 per share to one of its employees. At the issuance date, the fair value of these shares was determined by the fair market value of the shares issued as reflected by their market price at the issuance date in accordance with APB No. 25. In accordance with APB No. 25, the Company recorded this compensation expense of \$53,200 during 2004 and included this amount in general and administrative expenses

4. In December 2004, the Company donated 2,857 shares of its common stock to a charitable organization recognized by the Internal Revenue Service as tax-exempt under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to \$69,200 in accordance with EITF 96-18. This compensation expense will be amortized over the course of one year due to legal restrictions on selling these shares for that period of time. In accordance with EITF 96-18, the Company recorded compensation expense of \$4,361 and \$64,839 during 2004 and 2005, respectively, and included this amount in general and administrative expenses

5. In May 2005, the Company issued 5,190 shares of common stock to a consultant as commissions on battery orders as a part of a marketing agreement with the consultant whereby he helped procure orders and ensured payment by a specified military agency for Zinc-Air batteries and complementary products. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to \$89,363 in accordance with EITF 96-18. In accordance with EITF 96-18, the Company accrued compensation expenses of \$56,577 and \$32,786 during 2004 and 2005, respectively, and included these amounts in selling and marketing expenses.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

6. In August 2005, pursuant to the terms of agreements between the Company and an investment banker, the Company issued an aggregate of 30,357 shares of common stock as part of the fee arrangements in connection with investment banking and financial consulting services that the investment banker rendered to it including arranging financing in connection with potential acquisitions. At the issuance date, the fair value of these shares was determined by the value of the shares issued as reflected by their market price at the issuance date and amounted to \$423,750 in accordance with EITF 96-18. In accordance with EITF 96-18 the Company accrued compensation expenses of \$423,750 during 2005 and included this amount in general and administrative expenses.

7. In August 2005, pursuant to the terms of an agreement between the Company and a public relations firm, the Company issued 686 shares of common stock as part of the fee arrangements in connection with investor relations services that the public relations firm rendered to it. At the issuance date, the fair value of these shares was determined both by the value of the shares issued as reflected by their market price at the issuance date and by the value of the services provided and amounted to \$8,160 in accordance with EITF 96-18. In accordance with EITF 96-18 the Company accrued compensation expenses of \$8,160 during 2005 and included this amount in general and administrative expenses.

8. See Note 13.d.5.

d. Warrants:

1. In March 2006, 19,625 of the Company's warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received new warrants to purchase 7,850 shares at an exercise price of \$8.316. As a result of this repricing of the existing warrants and the issuance of these new warrants, the Company recorded during 2006 a deemed dividend in the amount of \$28,369.

On July 14, 2004, the Company repriced the exercise price of 17,316 warrants granted previously in May 2001 to \$26.32 in order to induce their holders to exercise them immediately. In connection with the exercise of the warrants, the Company additionally granted five-year warrants to purchase up to an aggregate of 10,390 shares of the Company's common stock at an exercise price per share of \$19.32. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years.

2. In connection with the Securities Purchase referred to in Note 13.b.1 above, the Company granted three-year warrants to purchase up to an aggregate of 702,888 shares of the Company's common stock at any time beginning six months after closing at an exercise price per share of \$26.32.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

In July 2004 an aggregate of 531,915 shares were issued pursuant to exercise of these warrants. In connection with the exercise of the warrants, the Company granted to the same investors five-year warrants to purchase up to an aggregate of 531,915 shares of the Company's common stock at an exercise price per share of \$19.32. The fair value of these warrants was determined using Black Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor of 79%, dividend yields of 0% and a contractual life of five years.

In March 2006, 56,991 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase an aggregate of 22,796 shares at an exercise price of \$8.316. In April 2006, an additional 75,988 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 30,395 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 a deemed dividend in the amount of \$270,336.

See also Note 13.d.3.

3. On July 14, 2004, warrants to purchase 629,588 shares of common stock, having an aggregate exercise price of \$16,494,194, net of issuance expenses, were exercised (see also Notes 13.d.1., 13.d.2. and 12.c.). Out of the shares issued in conjunction with the exercise of these warrants, 80,357 shares were issued upon exercise of warrants issued in the transaction referred to in Note 12.c. above and 531,915 shares were issued upon exercise of warrants issued in the transaction referred to in the Note 13.d.3. above; the remaining 17,316 shares were issued upon exercise of a warrant that the Company issued to an investor in May 2001 referred to in Note 13.d.1. above. In connection with this transaction, the Company issued to the holders of those exercising warrants an aggregate of 622,662 new five-year warrants to purchase shares of common stock at an exercise price of \$19.32 per share

As a result of the transactions described in Notes 13.d.1., 13.d.2. and 12.c., including the repricing of the warrants to the investors and the issuance of additional warrants to the investors, the Company recorded a deemed dividend in the amount of \$2,165,952, to reflect the additional benefit created for these investors. The deemed dividend increased the loss applicable to common stockholders in the calculation of basic and diluted net loss per share for the year ended December 31, 2004, without any effect on total shareholder's equity

As all warrants in the July 14, 2004, securities purchase agreement were subject to shareholders approval, in accordance with Emerging Issues Task Force No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date. Upon obtaining stockholders approval on December 14, 2004, the warrants were remeasured and reclassified to equity. The fair value of these warrants was determined using the Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of approximately five years. The change in the fair value of the warrants between the date of grant and December 14, 2004 has been recorded as finance income in the amount of \$326,839.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

In February and March 2006, an aggregate of 501,216 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holders of these warrants received new warrants to purchase an aggregate of 200,487 shares at an exercise price of \$8.316. In April 2006, an additional 16,071 of these warrants were repriced to an exercise price of \$5.60 per share and exercised. In connection with this repricing, the holder of these warrants received a new warrant to purchase 6,429 shares at an exercise price of \$8.316. As a result of these repricings of the existing warrants and the issuance of these new warrants, the Company recorded in 2006 deemed dividend in the amount of \$71,728.

As to EITF 00-19, since the terms of the new warrants referred to above provided that the warrants were exercisable subject to the Company obtaining shareholder approval, in accordance with Emerging Issues Task Force No 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," their fair value was recorded as a liability at the closing date. Such fair value was remeasured at each subsequent cut-off date until obtaining shareholder approval. The fair value of these warrants was remeasured as at June 19, 2006 (the date of the shareholder approval), using the Black-Scholes pricing model assuming a risk free interest rate of 5.00%, a volatility factor of 72%, dividend yields of 0% and a contractual life of approximately 1.78 years. The change in the fair value of the warrants between the date of the grant and June 19, 2006 in the amount of \$700,113 has been recorded as finance income.

4. In November 2000 and May 2001, the Company issued a total of 65,476 warrants to an investor, which warrants contained certain antidilution provisions: a Series A warrant to purchase 47,619 shares of the Company's common stock at a price of \$49.00 per share, and a Series C warrant to purchase 17,857 shares at a price of \$43.12 per share. Operation of the antidilution provisions provided that the Series A warrant should be adjusted to be a warrant to purchase 63,483 shares at a price of \$37.38 per share, and the Series C warrant should be adjusted to be a warrant to purchase 23,806 shares at a price of \$32.90 per share. After negotiations, the investor agreed in March 2004 to exercise its warrants immediately, in exchange for an exercise price reduction to \$20.30 per share, and the issuance of a new six-month Series D warrant to purchase 87,289 shares at an exercise price of \$29.40 per share. The new Series D warrant did not have similar antidilution provisions. As a result of this repricing and the issuance of new warrants, the Company recorded a deemed dividend in the amount of approximately \$1,163,000 in 2004.

5. On February 4, 2004, the Company entered into an agreement settling the litigation brought against it in the Tel-Aviv, Israel district court by I.E.S. Electronics Industries, Ltd. ("IES Electronics") and certain of its affiliates in connection with the Company's purchase of the assets of its IES Interactive Training, Inc. subsidiary from IES Electronics in August 2002. The litigation had sought monetary damages in the amount of approximately \$3.0 million. Pursuant to the terms of the settlement agreement, in addition to agreeing to dismiss their lawsuit with prejudice, IES Electronics agreed (i) to cancel the Company's \$450,000 debt to them that had been due on December 31, 2003, and (ii) to transfer to the Company title to certain certificates of deposit in the approximate principal amount of \$112,000. The parties also agreed to exchange mutual releases. In consideration of the foregoing, the Company issued to IES Electronics (i) 32,143 shares of common stock, and (ii) five-year warrants to purchase up to an additional 32,143 shares of common stock at a purchase price of \$26.74 per share. The fair value of the warrants was determined using Black-Scholes pricing model, assuming a risk-free interest rate of 3.5%, a volatility factor 79%, dividend yields of 0% and a contractual life of five years. The fair value of warrants was calculated as \$483,828 and fair value of shares as \$765,000. During 2004, 14,286 warrants were exercised.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

6. As of December 31, 2006, the Company's outstanding warrants totaled 1,049,709 with expiration dates through July 2009 with exercise prices ranging from \$8.32 to \$31.50.

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

1) 1998 Employee Option Plan - as amended, 339,286 shares reserved for issuance, of which 70,739 were available for future grants to employees and consultants as of December 31, 2006.

2) 1995 Non-Employee Director Plan - 71,429 shares reserved for issuance, of which 16,785 stock options were issued and outstanding as of December 31, 2006. Pursuant to the terms of this Plan, no new options were issuable under this Plan after September 28, 2005.

3) 2004 Employee Option Plan - 535,714 shares reserved for issuance, of which 222,650 were available for future grants to employees and consultants as of December 31, 2006.

b. 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 vest after two years or pursuant to defined performance criteria; in the event that employment is terminated within that period, unvested restricted shares revert back to the Company.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

c. A summary of the status of the Company's plans and other share options and restricted shares (except for options granted to consultants) granted as of December 31, 2006, 2005 and 2004, and changes during the years ended on those dates, is presented below:

	2006		2005		2004	
	Amount	Weighted average exercise price \$	Amount	Weighted average exercise price \$	Amount	Weighted average exercise price \$
Options outstanding at beginning of year	606,068	\$ 10.23	651,055	\$ 17.95	644,166	\$ 19.18
Changes during year:						
Granted (1) (2) (3)	124,000	\$ 2.86	116,811	\$ 7.95	107,749	\$ 22.13
Exercised	(1,786)	\$ 0.14	(1,130)	\$ 15.26	(64,089)	\$ 17.36
Forfeited (3)	(104,596)	\$ 13.75	(160,668)	\$ 26.90	(36,771)	\$ 52.78
Repriced						
Old exercise price	-	-	(207,980)	\$ 15.40	-	-
New exercise price	-	-	207,980	\$ 5.46	-	-
Options outstanding at end of year	<u>623,686</u>	<u>\$ 8.20</u>	<u>606,068</u>	<u>\$ 10.23</u>	<u>651,055</u>	<u>\$ 17.95</u>
Options vested at end of year	<u>486,526</u>	<u>\$ 9.22</u>	<u>592,362</u>	<u>\$ 9.98</u>	<u>639,959</u>	<u>\$ 19.24</u>

(1) Includes 12,500, 24,276 and 66,875 options granted to directors and executive officers in 2006, 2005 and 2004, respectively.

(2) The Company recorded deferred stock compensation for options and restricted shares issued with an exercise price below the fair value of the common stock in the amount of \$2,218,800, \$51,000 and \$2,081,457 as of December 31, 2006, 2005 and 2004, respectively. In addition, in 2005, the Company decreased its deferred stock compensation in the amount of \$245,280 due to cancellation of certain options and restricted shares of employees that their employment was terminated. Deferred stock compensation is amortized and recorded as compensation expenses ratably over the vesting period of the option or the restriction period of the restricted shares. The stock compensation expense that has been charged in the consolidated statements of operations in respect of options and restricted shares to employees and directors in 2006, 2005 and 2004 was \$500,545, \$674,713 and \$831,626, respectively.

(3) On December 29, 2005 the Company repriced downwards 207,980 options with an average exercise price of \$215.60 to \$76.44. In addition, 4,205 options with an exercise price of \$184.24 were forfeited and new options with an exercise price of \$76.44 were given at the same day. In accordance with FIN44 the downward repricing resulted in a variable plan accounting. However, due to the decrease in the share price as of December 31, 2005 no compensation was recorded

The table below summarize the intrinsic value of options for each year.

	Vested	Unvested
2006	\$ 1,039	\$ 31,220
2005	\$ 10,801	\$ -
2004	\$ 5,427,478	\$ 101,396

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

Restricted Shares:

	2006		2005		2004	
	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date	Shares	Weighted average fair value at grant date
Nonvested at the beginning of the year	54,286	\$ 1.41	52,857	\$ 1.45	-	-
Changes during year:						
Granted	860,000	\$ 2.58	4,286	\$ 1.12	52,857	\$ 1.45
Vested	(48,571)	\$ 1.42	-	-	-	-
Forfeited	(2,143)	\$ 1.73	(2,857)	\$ 1.73	-	-
Nonvested at the end of the year	863,572	\$ 2.51	54,286	\$ 1.41	52,857	\$ 1.45
Restricted shares vested at end of year	48,571	\$ 1.42	-	-	-	-

d. The options outstanding as of December 31, 2006 have been separated into ranges of exercise price, as follows:

Range of exercise prices	Total options outstanding			Vested options outstanding	
	Amount outstanding at December 31, 2006	Weighted average remaining contractual life	Weighted average exercise price	Amount exercisable at December 31, 2006	Weighted average exercise price
		Years	\$		\$
0.00-28.00	596,075	3.93	6.29	463,085	7.03
28.01-56.00	16,183	2.43	34.29	12,018	34.53
56.01-84.00	10,356	3.61	66.62	10,356	66.62
84.01-112.00	353	0.87	90.76	353	90.76
112.01	719	0.75	126.88	714	126.88
	623,686	3.88	8.20	486,526	9.22

On December 29, 2005, the Company accelerated vesting of 39,810 of its outstanding unvested stock options to make such options immediately vested and exercisable. The Company's decision to accelerate the vesting of those options and to grant fully vested options was based primarily upon the issuance of SFAS No. 123R, which will require the Company to treat all unvested stock options as compensation expense effective January 1, 2006. The Company believes that the acceleration of vesting of those options will enable the Company to avoid recognizing stock-based compensation expense associated with these options in future periods. Additional reasons for the fully vested grant and for the acceleration were to make the options more attractive to the recipients, and to avoid discrimination between groups of option holders, respectively.

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AROTECH CORPORATION AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

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

	Equals market price			Less than market price		
	Year ended December 31,			Year ended December 31,		
	2006	2005	2004	2006	2005	2004
Weighted average exercise prices	\$ 2.86	\$ 7.00	\$ 20.92	\$ -	\$ -	\$ 23.41
Weighted average fair value on grant date	\$ 2.11	\$ 3.64	\$ 14.03	\$ -	\$ -	\$ 24.21

2. Options issued to consultants:

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

	2006		2005		2004	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
		\$		\$		\$
Options outstanding at beginning of year	11,878	\$ 53.20	11,878	\$ 53.20	22,422	\$ 64.26
Changes during year:						
Granted	10,000	\$ 1.90	-	\$ -	714	\$ -
Exercised	10,000	\$ 1.90	-	\$ -	(2,687)	\$ 14.42
Forfeited or cancelled	-	\$ -	-	\$ -	(8,571)	\$ 89.60
Options outstanding at end of year	11,878	\$ 29.75	11,878	\$ 53.20	11,878	\$ 53.20
Options vested at end of year	11,878	\$ 29.75	11,878	\$ 53.20	11,878	\$ 53.20

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

	2006	2005	2004
Dividend yield	0%	-	0%
Expected volatility	84.8%	-	81%
Risk-free interest	4.58%	-	3.4%
Contractual life of up to	1 year	-	5 years

c. In connection with the grant of stock options to consultants, the Company recorded stock compensation expenses totaling \$6,563, \$0 and \$0 for the years ended December 31, 2006, 2005 and 2004, respectively, and included these amounts in general and administrative expenses.

d. The remaining total compensation cost related to non-vested stock options and restricted share awards not yet recognized in the income statement as of December 31, 2006 was \$2,476,670, of which \$284,794 was for stock options and \$2,191,876 was for restricted shares. The

weighted average period over which this compensation cost is expected to be recognized is approximately 14 months.

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 13:- STOCKHOLDERS' EQUITY (Cont.)

3. Dividends:

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

4. Treasury Stock:

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

NOTE 14:- INCOME TAXES

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

As of December 31, 2006, Arotech has operating loss carryforwards for U.S. federal income tax purposes of approximately \$35.6 million, which are available to offset future taxable income, if any, expiring in 2009 through 2026. Utilization of U.S net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

The Company files consolidated tax returns with its US subsidiaries.

b. Israeli subsidiary (Epsilor):

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

Currently, Epsilor is operating under two programs as follows:

1. Program one:

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

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

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

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

2. Program two:

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

Epsilor's expansion program of its existing enterprise in Dimona was granted the status of an "approved enterprise" under the Investments Law, and is entitled to investments grants from the State of Israel in the amount of 32% on property and equipment located at its Dimona plant.

The approved expansion program is in the amount of approximately \$945,000. This program has not yet received final approval.

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

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

The main tax benefits available to Epsilor are:

a) Reduced tax rates:

As stated above for each specific program

b) Accelerated depreciation:

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

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 31%.

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

Dividends paid from the profits of an approved enterprise are subject to tax at the rate of 15% in the hands of their recipient.

As of December 31, 2006 there are no tax exempt profits earned by Epsilor's "approved enterprises" by Israel law that will be distributed as a dividend and accordingly no deferred tax liability was recorded as of December 31, 2006. Furthermore, management has indicated that it has no intention of declaring any dividend.

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the existing Approved Enterprise of the Israeli subsidiary's will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Amended Investment Law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2006, the Company did not generate income under the provision of the amended Investment Law.

c. Other tax information about the Israeli subsidiaries:

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

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

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

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

3. Tax rates applicable to income from other sources:

Income from sources other than the "Approved Enterprise," is taxed at the regular rate of 34%. See also Note 14.e.

4. Tax loss carryforwards:

As of December 31, 2006, EFL has operating and capital loss carryforwards for Israeli tax purposes of approximately \$90.0 million, which are available, indefinitely, to offset future taxable income.

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

Until December 31, 2003, the regular tax rate applicable to income of companies (which are not entitled to benefits due to "approved enterprise", as described above) was 36%. In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the Knesset (Israeli parliament) and on July 25, 2005, another law was passed, the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
In U.S. dollars
NOTE 14:- INCOME TAXES (Cont.)

f. Deferred income taxes:

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

	December 31,	
	2006	2005
Operating loss carryforward ⁽¹⁾	\$ 33,222,692	\$ 32,326,283
Other temporary differences	6,292,079	2,222,333
Net deferred tax asset before valuation allowance	39,514,771	34,548,616
Valuation allowance	(39,456,739)	(34,483,796)
Total deferred tax asset	\$ 58,032	\$ 64,820
Deferred tax liability	\$ -	\$ -

(1)

	December 31,	
	2006	2005
Domestic	\$ 11,627,401	\$ 8,981,133
Foreign	21,595,291	23,345,150
	\$ 33,222,692	\$ 32,326,283

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that it is more likely than not that the deferred tax assets related to the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2006 was \$4,972,943

g. Loss from continuing operations before taxes on income and minorities interests in loss (earnings) of a subsidiary:

	Year ended December 31		
	2006	2005	2004
Domestic	\$ 13,014,325	\$ 21,473,366	\$ 8,006,205
Foreign	2,340,082	2,269,522	405,305
	\$ 15,354,407	\$ 23,742,888	\$ 8,411,510

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AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars

NOTE 14:- INCOME TAXES (Cont.)

h. Taxes on income were comprised of the following:

	Year ended December 31		
	2006	2005	2004
Current state and local taxes	\$ 225,371	\$ 83,365	\$ 539,674
Deferred taxes	6,788	14,345	(37,857)
Taxes in respect of prior years	-	139,962	84,292
	<u>\$ 232,159</u>	<u>\$ 237,672</u>	<u>\$ 586,109</u>
Domestic	\$ 49,383	\$ 153,950	\$ 163,087
Foreign	182,776	83,722	423,022
	<u>\$ 232,159</u>	<u>\$ 237,672</u>	<u>\$ 586,109</u>

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

	Year ended December 31,		
	2006	2005	2004
Loss from continuing operations before taxes, as reported in the consolidated statements of income	<u>\$ (15,354,407)</u>	<u>\$ (23,742,888)</u>	<u>\$ (8,411,510)</u>
Statutory tax rate	34%	34%	34%
Theoretical income tax on the above amount at the U.S. statutory tax rate	\$ (5,220,498)	\$ (8,072,582)	\$ (2,859,914)
Deferred taxes on losses for which valuation allowance was provided	2,745,964	1,611,971	556,692
Non-deductible expenses	2,793,214	5,669,144	1,629,874
State taxes	49,383	67,470	168,081
Accrual for deferred taxes on undistributed earnings	-	(49,328)	49,416
Foreign income in tax rates other than U.S rate	(141,822)	897,617	919,895
Taxes in respect of prior years	-	139,963	84,292
Others	5,918	(26,583)	37,773
Actual tax expense	<u>\$ 232,159</u>	<u>\$ 237,672</u>	<u>\$ 586,109</u>

AROTECH CORPORATION AND ITS SUBSIDIARIES
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In U.S. dollars

NOTE 15:- SELECTED STATEMENTS OF OPERATIONS DATA

Financial income (expenses), net:

	Year ended December 31,		
	2006	2005	2004
Financial expenses:			
Interest, bank charges and fees	\$ (2,018,061)	\$ (1,473,799)	\$ (622,638)
Amortization related to warrants issued to the holders of convertible debentures and beneficial conversion feature	(1,485,015)	(1,702,753)	(4,142,109)
Expenses in connection with convertible debenture principle repayment and inducement	(5,395,338)	-	-
Bonds premium amortization	-	(47,734)	(202,467)
Other	(35,332)	-	-
Foreign currency translation differences	-	(54,840)	(71,891)
	<u>(8,933,746)</u>	<u>(3,279,126)</u>	<u>(5,039,105)</u>
Financial income:			
Interest	646,583	192,771	443,182
Foreign currency translation differences	67,150	-	-
Realized gain from marketable securities sale	-	2,863	40,119
Financial income in connection with warrants granted (Note 12.d. and 13.d.3.)	<u>700,113</u>	<u>377,803</u>	<u>326,839</u>
Total	<u>\$ (7,519,900)</u>	<u>\$ (2,705,689)</u>	<u>\$ (4,228,965)</u>

NOTE 16:- SEGMENT INFORMATION

a. General:

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

Prior to its purchase of FAAC, Epsilor and AoA, the Company had managed its business in two reportable segments organized on the basis of differences in its related products and services. With the acquisition of FAAC and Epsilor early in 2004 and AoA in August of 2004, the Company reorganized into three segments: Simulation and Training (formerly known as Simulation and Security); Armor; and Battery and Power Systems. As a result the Company restated information previously reported in order to comply with new segment reporting.

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
In U.S. dollars

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

	Simulation and Training	Armor	Battery and Power Systems	All Others	Total
2006					
Revenues from outside customers	\$ 21,951,337	\$ 12,571,779	\$ 8,597,623	\$ -	\$ 43,120,739
Depreciation , amortization and impairment expenses ⁽¹⁾	(1,708,012)	(1,077,416)	(844,431)	(350,308)	(3,980,167)
Direct expenses ⁽²⁾	(18,256,933)	(13,252,233)	(8,768,088)	(6,912,577)	(47,189,831)
Segment net income (loss)	<u>\$ 1,986,392</u>	<u>\$ (1,757,870)</u>	<u>\$ (1,014,896)</u>	<u>\$ (7,262,885)</u>	<u>(8,049,259)</u>
Financial expenses (after deduction of minority interest)					(7,519,900)
Net loss from continuing operations					<u>\$ (15,569,159)</u>
Segment assets ^{(3) (4)}	<u>\$ 43,753,369</u>	<u>\$ 9,523,126</u>	<u>\$ 18,184,133</u>	<u>\$ 3,607,645</u>	<u>\$ 75,068,274</u>
2005					
Revenues from outside customers	\$ 26,805,772	\$ 12,322,678	\$ 9,916,145	\$ -	\$ 49,044,595
Depreciation , amortization and impairment expenses ⁽¹⁾	(1,645,057)	(14,043,019)	(909,463)	(229,626)	(16,827,165)
Direct expenses ⁽²⁾	(21,967,755)	(13,955,199)	(9,757,402)	(7,752,865)	(53,433,221)
Segment net income (loss)	<u>\$ 3,192,960</u>	<u>\$ (15,675,540)</u>	<u>\$ (750,720)</u>	<u>\$ (7,982,491)</u>	<u>(21,215,791)</u>
Financial expenses (after deduction of minority interest)					(2,707,620)
Net loss from continuing operations					<u>\$ (23,923,411)</u>
Segment assets ^{(3) (4)}	<u>\$ 47,302,499</u>	<u>\$ 10,163,782</u>	<u>\$ 16,738,648</u>	<u>\$ 10,663,744</u>	<u>\$ 84,868,673</u>
2004					
Revenues from outside customers	\$ 21,464,406	\$ 17,988,687	\$ 10,500,753	\$ -	\$ 49,953,846
Depreciation , amortization and impairment expenses ⁽¹⁾	(1,983,822)	(1,755,847)	(1,132,953)	(135,613)	(5,008,235)
Direct expenses ⁽²⁾	(17,910,967)	(16,444,476)	(9,974,544)	(5,431,627)	(49,761,614)
Segment net income (loss)	<u>\$ 1,569,617</u>	<u>\$ (211,636)</u>	<u>\$ (606,744)</u>	<u>\$ (5,567,240)</u>	<u>(4,816,003)</u>
Financial expenses (after deduction of minority interest)					(4,226,310)
Net loss from continuing operations					<u>\$ (9,042,313)</u>
Segment assets ⁽³⁾	<u>\$ 42,416,974</u>	<u>\$ 23,822,000</u>	<u>\$ 17,918,566</u>	<u>\$ 14,134,647</u>	<u>\$ 98,292,187</u>

⁽¹⁾ Includes depreciation of property and equipment, amortization expenses of intangible assets and impairment of goodwill and other intangible assets.

⁽²⁾ Including, *inter alia*, sales and marketing, general and administrative and tax expenses.

⁽³⁾ Consisting of all assets.

⁽⁴⁾ Out of those amounts, goodwill in the Company's Simulation and Training, Battery and Power Systems and Armor Divisions stood at \$24,235,419, \$5,413,210 and \$1,066,596 as of December 31, 2006, \$23,605,069, \$4,968,676 and \$985,412 as of December 31, 2005, respectively, and \$22,845,372, \$5,308,917 and \$11,591,227 as of December 31, 2004, respectively.

AROTECH CORPORATION AND ITS 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 end customers location for the years ended December 31, 2006, 2005 and 2004, and long-lived assets as of December 31, 2006, 2005 and 2004

	2006		2005		2004	
	Total	Long-lived	Total	Long-lived	Total	Long-lived
	revenues	assets	revenues	assets	revenues	assets
	U.S. dollars					
U.S.A.	\$ 32,945,951	\$ 31,860,632	\$ 38,953,462	\$ 32,840,172	\$ 40,656,729	\$ 45,154,086
Germany	387,612	-	188,635	-	319,110	-
England	240,712	-	931,008	-	344,261	-
Thailand	-	-	-	-	-	-
India	1,388,401	-	1,723,031	-	3,061,705	-
Israel	5,658,986	12,123,400	5,700,267	11,999,415	4,212,408	13,560,822
Other	2,499,077	-	1,548,192	-	1,359,633	-
	\$ 43,120,739	\$ 43,958,032	\$ 49,044,595	\$ 44,839,587	\$ 49,953,846	\$ 58,714,908

d. Revenues from major customers:

	Year ended December 31,		
	2006	2005	2004
Batteries and power systems:			
Customer A	6%	7%	8%
Armor:			
Customer B	5%	5%	4%
Customer C	18%	9%	24%
Simulation and Training:			
Customer D	34%	24%	13%
Customer E	-	-	1%

e. Revenues from major products:

	Year ended December 31,		
	2006	2005	2004
Electric vehicle	\$ -	\$ 205,485	\$ 232,394
Water activated batteries	1,660,521	1,181,114	921,533
Military batteries	6,937,101	8,515,329	9,324,247
Car and aircraft armoring	12,571,779	12,322,679	17,988,686

Simulators	21,951,338	26,785,772	21,414,968
Other	<u>-</u>	<u>34,216</u>	<u>72,018</u>
Total	<u>\$ 43,120,739</u>	<u>\$ 49,044,595</u>	<u>\$ 49,953,846</u>

NOTE 17:- SUBSEQUENT EVENTS

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

AROTECH CORPORATION AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In U.S. dollars**NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED) (Cont.)**

The Company has learned that on March 23, 2007, a purported class action complaint (the "Complaint") was apparently filed in the United States District Court for the Eastern District of Michigan against the Company and certain of its officers and directors (the "Individual Defendants"). Although the Company has yet to be served with a copy of the Complaint, the Complaint apparently seeks class status on behalf of all persons who purchased the Company's securities between March 31, 2005 and November 14, 2005 (the "Period") and alleges violations by the Company and the Individual Defendants of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder, primarily related to the Company's acquisition of Armour of America in 2005 and certain public statements made by the Company with respect to its business and prospects during the Period. The Complaint also alleges that the Company did not have adequate systems of internal operational or financial controls, and that the Company's financial statements and reports were not prepared in accordance with GAAP and SEC rules. The Complaint seeks an unspecified amount of damages.

SUPPLEMENTARY FINANCIAL DATA

Quarterly Financial Data (unaudited) for the two years ended December 31, 2006

2006	Quarter Ended			
	March 31	June 30	September 30	December 31
Net revenue	\$ 8,896,412	\$ 7,414,335	\$ 12,722,686	\$ 14,087,306
Net loss from continuing operations	\$ (4,213,448)	\$ (8,215,335)	\$ (1,065,223)	\$ (2,075,153)
Net loss for the period	\$ (4,213,448)	\$ (8,215,335)	\$ (1,065,223)	\$ (2,075,153)
Deemed dividend to certain stockholders of common stock	\$ (317,207)	\$ (116,978)	\$ -	\$ -
Net loss attributable to common stockholders	\$ (4,530,655)	\$ (8,332,313)	\$ (1,065,223)	\$ (2,075,153)
Net loss per share - basic and diluted	\$ (0.62)	\$ (0.97)	\$ (0.09)	\$ (0.19)
Shares used in per share calculation	7,267,899	8,469,099	10,585,488	10,787,695

2005	Quarter Ended			
	March 31	June 30	September 30	December 31
Net revenue	\$ 10,387,445	\$ 12,236,910	\$ 11,189,675	\$ 15,230,565
Net loss from continuing operations	\$ (2,456,500)	\$ (5,422,514)	\$ (12,708,932)	\$ (3,335,465)
Net profit (loss) from discontinued operations	\$ -	\$ (200,000)	\$ -	\$ 80,000
Net loss for the period	\$ (2,456,500)	\$ (5,622,514)	\$ (12,708,932)	\$ (3,255,465)
Deemed dividend to certain stockholders of common stock	\$ -	\$ -	\$ -	\$ -
Net loss attributable to common stockholders	\$ (2,456,500)	\$ (5,622,514)	\$ (12,708,932)	\$ (3,255,465)
Net loss per share - basic and diluted	\$ (0.43)	\$ (0.97)	\$ (2.16)	\$ (0.53)
Shares used in per share calculation	5,721,578	5,770,011	5,891,127	6,103,348

FINANCIAL STATEMENT SCHEDULE

Arotech Corporation and Subsidiaries

Schedule II - Valuation and Qualifying Accounts

For the Years Ended December 31, 2006, 2005 and 2004

Description	Balance at beginning of period	Additions charged to costs and expenses*	Balance at end of period
Year ended December 31, 2006			
Allowance for doubtful accounts	\$ 176,000	\$ (17,000)	\$ 159,000
Allowance for slow moving inventory	1,280,000	293,000	1,573,000
Valuation allowance for deferred taxes	34,484,000	4,973,000	39,457,000
Totals	<u>\$ 35,940,000</u>	<u>\$ 5,224,000</u>	<u>\$ 41,189,000</u>
Year ended December 31, 2005			
Allowance for doubtful accounts	\$ 55,000	\$ 121,000	\$ 176,000
Allowance for slow moving inventory	218,000	1,062,000	1,280,000
Valuation allowance for deferred taxes	33,726,000	758,000	34,484,000
Totals	<u>\$ 33,999,000</u>	<u>\$ 1,941,000</u>	<u>\$ 35,940,000</u>
Year ended December 31, 2004			
Allowance for doubtful accounts	\$ 61,000	\$ (6,000)	\$ 55,000
Allowance for slow moving inventory	96,000	122,000	218,000
Valuation allowance for deferred taxes	34,802,000	(1,076,000)	33,726,000
Totals	<u>\$ 34,959,000</u>	<u>\$ (960,000)</u>	<u>\$ 33,999,000</u>

*The 2006 valuation allowance includes an adjustment to the prior year provision calculation due to changes recognized in the preparation of the actual returns.

AMENDED AND
RESTATED CERTIFICATE OF INCORPORATION
OF
ELECTRIC FUEL CORPORATION

Electric Fuel Corporation, a corporation duly organized and existing under the laws of the State of Delaware, hereby certifies as follows:

1. The name of this corporation is Electric Fuel Corporation. Electric Fuel Corporation was originally incorporated under the name of Luz Electric Fuel, Inc. The date of the filing of its original Certificate of Incorporation with the Secretary of State was December 20, 1990.
2. This Amended and Restated Certificate of Incorporation restates and integrates and further amends the provisions of the corporation's Certificate of Incorporation as amended and supplemented. This Amended and Restated Certificate of Incorporation has been adopted by the Board of Directors and the stockholders of the Company in accordance with Sections 245(b) and 242 of the Delaware Corporation Law.
3. The text of the Amended and Restated Certificate of Incorporation is amended to read in its entirety as follows:

STATE OF DELAWARE
SECRETARY OF STATE
DIVISION OF CORPORATIONS
FILED 08:30 AM 03/02/1994
944031364 - 2249957

AMENDED AND
RESTATED CERTIFICATE OF INCORPORATION
OF
ELECTRIC FUEL CORPORATION

ONE: The name of this corporation is Electric Fuel Corporation.

TWO: The address of its registered office in the State of Delaware is 1013 Centre Road, Wilmington, County of New Castle. The name of its registered agent at such address is Corporation Service Company.

THREE: The nature of the business or purposes to be conducted or promoted is to engage in any lawful act or activity for which corporations may be organized under the Delaware General Corporation Law ("DGCL").

FOUR: The total number of shares of all classes of stock which the corporation shall have authority to issue is Fifteen Million (15,000,000) consisting of two classes of shares designated as follows:

A. Fourteen Million (14,000,000) shares of Common Stock, \$.01 par value, (the "Common Stock"); and

B. One Million (1,000,000) shares of Preferred Stock, \$.01 par value, (the "Preferred Stock").

FIVE: The rights, preferences, privileges and restrictions granted to or imposed upon the respective classes of shares or the holders thereof are as follows:

A. Preferred Stock.

1. The Preferred Stock may be issued from time to time in one or more series. All shares of any one series of Preferred Stock shall be identical in all respects, except that shares of any one series issued on different dates may differ as to dates, if any, from which dividends thereon are to cumulate.

2. The Board of Directors of the corporation is expressly granted the authority, at any time and from time to time by the adoption of a resolution or resolutions not inconsistent with the provisions of the Amended and Restated Certificate of Incorporation, to authorize the issuance by this corporation of one or more series of Preferred Stock and to fix and determine with respect to each such series all the designations, preferences, powers and relative, participating, optional or other special rights, and the qualifications, limitations or restrictions thereof, to the full extent now or

hereafter permitted by law, and including, but without limiting the generality of the foregoing, the following:

(a) the number of shares of such series, which may subsequently be increased (except as otherwise provided by the resolution or resolutions of the Board of Directors providing for the issuance of such series) or decrease (to a number not less than the number of shares then outstanding) by resolution or resolutions of the Board of Directors, and the distinctive designations thereof;

(b) the dividend rights of such series, the preferences, if any, over any other class or series of stock, or of any other class or series of stock over such series, as to dividends, the extent, if any, to which shares of such series shall be entitled to participate in dividends with shares of any other class of stock, whether dividends on shares of such series shall be fully, partially or conditionally cumulative, or a combination thereof, and any limitations, restrictions or conditions on the payment of such dividends;

(c) the rights of such series, and the preferences, if any, over any other class or series of stock, or of any other class or series of stock over such series, in the event of any voluntary or involuntary liquidation, dissolution or winding up of this corporation and the extent, if any, to which shares of any such series shall be entitled to participate in such event with any other series or class of stock;

(d) whether or not the shares of such series shall be redeemable, and, if redeemable, the date or dates upon or after which they shall become redeemable, the amount per share payable thereon in the case of the redemption thereof, which amount may vary at different redemption dates;

(e) the terms of any purchase, retirement or sinking fund which may be provided for the shares of such series;

(f) the right, if any, of holders of shares of such series to convert the same into, or exchange the same for Common Stock, and the terms and conditions of such conversion or exchange, as well as provisions for adjustment of the conversion rate in such events as the Board of Directors shall determine; and,

(g) the voting powers, if any, of such series in addition to the voting powers by law.

3. In the event of any liquidation, dissolution, or winding up of this corporation, whether voluntary or involuntary, the holders of the Preferred Stock of each series shall be entitled to receive only such amount or amounts as shall have

been fixed by the Amended and Restated Certificate of Incorporation or by the resolution or resolutions of the Board of Directors providing for the issuance of such series.

B. Common Stock.

1. The holders of Common Stock shall be entitled to one vote for each share of Common Stock registered in the name of such holders.

2. The holders of Common Stock shall be entitled to receive dividends on their shares of stock when and as declared by this corporation's Board of Directors. All dividends declared on the Common Stock shall be declared and paid at the same rate per share on all shares of Common Stock.

3. In the event of the liquidation, dissolution or winding up of the affairs of the corporation, the holders of the Common Stock shall be entitled to share pro rata in the net assets available for distribution to holders of Common Stock after satisfaction of the prior claims of the holders of Preferred Stock of any series or and shares of any other class of capital stock ranking senior to the Common Stock as to assets, in accordance with this Amended and Restated Certificate of Incorporation, as amended from time to time, or of resolutions of the Board of Directors adopted pursuant to the authority herein contained.

SIX: The provisions of Section 203 of the DGCL shall not apply to this Corporation.

SEVEN: The following provisions are inserted for the management of the business and the conduct of the affairs of the corporation, and for further definition, limitation and regulation of the powers of the corporation and of its directors and stockholders:

A. The business and affairs of the corporation shall be managed by or under the direction of the Board of Directors. In addition to the powers and authority expressly conferred upon them by the DGCL or by this Amended and Restated Certificate of Incorporation or the Bylaws of the corporation, the directors are hereby empowered to exercise all such powers and do all such acts and things as may be exercised or done by the corporation.

B. Except as otherwise provided in this Amended and Restated Certificate of Incorporation, or the By-Laws of the Corporation relating to the rights of the holders of any class or series of Preferred Stock, voting separately by class or series, to elect additional directors under specified circumstances, the number of directors of the Corporation shall be fixed from time to time by or pursuant to the By-Laws of the Corporation. The

election of directors need not be by ballot unless the by-laws shall so require. The directors, other than those who may be elected by the holders of any class or series of Preferred Stock voting separately by class or series, shall be classified, with respect to the time for which they severally hold office, into three classes, Class I, Class II and Class III, which shall be as nearly equal in number as possible. Each director holding office as of the date of adoption of this Amended and Restated Certificate of Incorporation (each an "Initial Director"), classified in Class I shall hold office for a term expiring at the 1994 annual meeting of stockholders; each Initial Director in Class II shall hold office for a term expiring at the 1995 annual meeting of stockholders; and each Initial Director in Class III shall hold office for a term expiring at the 1996 annual meeting of stockholders. Notwithstanding the foregoing provision of this paragraph B, each director shall serve until his successor is duly elected and qualified or until his earlier death, resignation or removal. At each annual meeting of stockholders following the 1993 annual meeting, the successors to the class of directors whose term expires at that meeting shall be elected to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election and until their successors have been duly elected and qualified or until their earlier death, resignation or removal.

C. Except as otherwise provided pursuant to the provisions of this Amended and Restated Certificate of Incorporation or the By-laws of the Corporation relating to the rights of the holders of any class or series of Preferred Stock, voting separately by class or series, to elect directors under specified circumstances, any director or directors may be removed from office at any time, but only for cause, by the affirmative vote, at any regular meeting or special meeting of the stockholders, of not less than 85% of the total number of votes of the then outstanding shares of capital stock of the Corporation entitled to vote generally in the election of directors, voting together as a single class, and only if notice of such proposal was contained in the notice of such meeting. Any vacancy in the Board of Directors resulting from any such removal may be filled by vote of a majority of the directors then in office, although less than a quorum, and any director or directors so chosen shall hold office until the next election of the class for which such directors shall have been chosen and until their successors shall be elected and qualified or until their earlier death, resignation or removal.

D. Notwithstanding any other provision of this Amended and Restated Certificate of Incorporation or the By-laws of the Corporation (and notwithstanding the fact that a lesser percentage may be specified by law, this Amended and Restated Certificate of Incorporation or the By-laws of the Corporation), the affirmative vote, at any regular meeting or special meeting

of the stockholders, of not less than 85% of the total number of votes of the then outstanding shares of capital stock of the Corporation entitled to vote generally in the election of directors, voting together as a single class, shall be required to amend or repeal, or to adopt any provision inconsistent with the purpose or intent of, this paragraph SEVEN. Notice of such proposed alteration or amendment must be contained in the notice of such meeting.

E. In the event of any increase or decrease in the authorized number of directors, the newly created or eliminated directorship resulting from such increase or decrease shall be allotted by the Board of Directors among the three classes of directors so as to maintain such classes as nearly equally as possible. No decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

F. Notwithstanding the foregoing, whenever the holders of any one or more classes or series of Preferred Stock issued by the Corporation shall have the right, voting separately by class or series, to elect directors at an annual or special meeting of stockholders, the election, term of office, filling of vacancies and other features of such directorships shall be governed by the terms of this Amended and Restated Certificate of Incorporation applicable thereto, and such directors so elected shall not be divided into classes pursuant to paragraph B unless expressly provided for by the terms of the instrument establishing the right to vote separately as a class or series for the purpose of electing directors.

EIGHT: A director of the corporation in exercising his duties as such, including without limitation, evaluating a tender offer or exchange offer for any equity security of the corporation or any merger or consolidation of the corporation, any sale, lease, exchange or transfer of all or any substantial part of the assets of the corporation, the issuance of any securities of the corporation, the acquisition of any securities of a third party or any reclassification, recapitalization or reorganization of the corporation or any of its securities, may consider the following factors as the Board of Directors determines to be relevant, including, without limitation: (i) the interests of the corporation's stockholders; (ii) whether the proposed transaction may violate federal or state laws; (iii) not only the consideration being offered in the proposed transaction, in relation to the then current market price for the outstanding capital stock of the corporation, but also the market price for the capital stock of the corporation over a period of years, the estimated price that might be achieved in a negotiated sale of the corporation as a whole or in part or through orderly liquidation, the premiums over market price for the securities of other corporations in similar transactions, current political,

economic and other factors bearing on securities prices and the corporation's financial condition and future prospects; and (iv) the interests of the corporation's employees, suppliers, creditors and customers, the economy of the state, region and nation, community and societal considerations, and the long-term and short-term interests of the corporation and its stockholders, including the possibility that these interests may best be served by the continued independence of the corporation. In connection with any such evaluation, the Board of Directors is authorized to conduct such investigations and to engage in such legal proceedings as the Board of Directors may determine.

NINE: The officers of the corporation shall be chosen in such a manner, shall hold their offices for such terms and shall carry out such duties as are determined solely by the Board of Directors, subject to the right of the Board of Directors to remove any officer or officers at any time with or without cause.

TEN: No director of the corporation shall be personally liable to the corporation or its stockholders for monetary damages for any breach of fiduciary duty by such a director as a director. Notwithstanding the foregoing sentence, a director shall be liable to the extent provided by applicable law (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) pursuant to Section 174 of the DGCL or (iv) for any transaction from which such director derived an improper personal benefit. No amendment to or repeal of this Article NINE shall apply to or have any affect on the liability or alleged liability of any director of the corporation for or with respect to any acts or omissions of such director occurring prior to such amendment or repeal. If the DGCL is amended hereafter to further eliminate or limit the personal liability of directors, the liability of a director of this corporation shall be limited or eliminated to the fullest extent permitted by the DGCL, as amended.

ELEVEN: This corporation shall, to the maximum extent permitted from time to time under the DGCL, indemnify and upon request shall advance expenses to any person who is or was a party or is threatened to be made a party to any threatened, pending or completed action, suit, proceeding or claim, whether civil, criminal, administrative or investigative, by reason of the fact that such person is or was or has agreed to be a director or officer of this corporation or while a director or officer is or was serving at the request of this corporation as a director, officer, partner, trustee, employee or agent of any corporation, partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, against expenses (including attorney's fees and expenses),

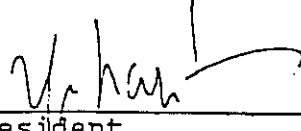
judgments, fines, penalties and amounts paid in settlement incurred in connection with the investigation, preparation to defend or defense of such action, suit, proceeding or claim; provided, however, that the foregoing shall not require this corporation to indemnify or advance expenses to any person in connection with any action, suit, proceeding, claim or counterclaim initiated by or on behalf of such person. Such indemnification shall not be exclusive of other indemnification rights arising under any by-law, agreement, vote of directors or stockholders or otherwise and shall inure to the benefit of the heirs and legal representatives of such person. Any person seeking indemnification under this paragraph 11 shall be deemed to have met the standard of conduct required for such indemnification unless the contrary shall be established. Any repeal or modification of the foregoing provisions of this paragraph 11 shall not adversely affect any right or protection of a director or officer of this corporation with respect to any acts or omissions of such director or officer occurring prior to such repeal or modification.

TWELVE: The books of this corporation may (subject to any statutory requirements) be kept outside the State of Delaware as may be designated by the Board of Directors or in the By-Laws of this corporation.

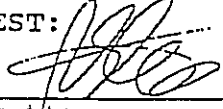
THIRTEEN: The corporation reserves the right to repeal, alter, amend, or rescind any provision contained in this Amended and Restated Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights conferred on stockholders herein are granted subject to this reservation.

IN WITNESS WHEREOF, Electric Fuel Corporation has caused this Amended and Restated Certificate of Amendment to be signed by its President and attested by its Secretary this 2nd day of March, 1994.

ELECTRIC FUEL CORPORATION

By: 
President

ATTEST:


Secretary

CERTIFICATE OF AMENDMENT
TO THE RESTATED CERTIFICATE OF INCORPORATION

of

ELECTRIC FUEL CORPORATION

Electric Fuel Corporation, a corporation organized and existing under and by virtue of the General Corporation Law of the State of Delaware, DOES HEREBY CERTIFY:

FIRST: That in a unanimous written consent of the Board of Directors of this corporation a resolution was duly adopted setting forth a proposed amendment to the Amended and Restated Certificate of Incorporation of said corporation, declaring said amendment to be advisable and calling for the presentation of said amendment at the annual meeting of the stockholders of said corporation for consideration thereof. The resolution setting forth the proposed amendment is as follows:

RESOLVED: That Article Four of the Corporation's Amended and Restated Certificate of Incorporation be amended to read in its entirety as follows:

"FOUR: The total number of shares of all classes of stock which the corporation shall have authority to issue is Twenty-nine Million (29,000,000) consisting of two classes of shares designated as follows:

A. Twenty-eight Million (28,000,000) shares of Common Stock, \$.01 par value (the "Common Stock"), and

B. One Million (1,000,000) shares of Preferred Stock, \$.01 par value (the "Preferred Stock")."

and that such amendment is attached hereto as Exhibit A.

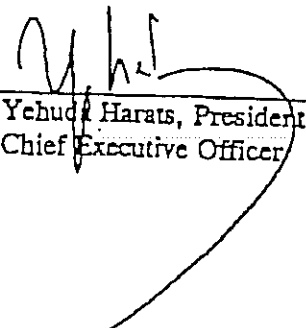
SECOND: That thereafter pursuant to resolution of its Board of Directors the Annual Meeting of the Stockholders of said corporation was duly called and held, upon notice in accordance with Section 222 of the General Corporation Law of the State of Delaware, at which meeting a majority of the outstanding stock of the corporation entitled to vote thereon was voted in favor of the amendments.

THIRD: That said amendments were duly adopted in accordance with the provisions of Section 242 of the General Corporation Law of the State of Delaware.

IN WITNESS WHEREOF, said corporation has caused this certificate to be signed by Yehuda Harats, its President and Chief Executive Officer and attested by Robert S. Ehrlich, its Chairman of the Board, Chief Financial Officer and Secretary, this 24th day of June, 1996.

ELECTRIC FUEL CORPORATION

By


Yehuda Harats, President and
Chief Executive Officer

ATTEST:


Robert S. Ehrlich, Chairman of the Board,
Chief Financial Officer and Secretary

ELECTRIC FUEL CORPORATION

AMENDMENT TO ARTICLE FOUR OF THE CORPORATION'S AMENDED AND
RESTATED CERTIFICATE OF INCORPORATION (THE "CHARTER")

FOUR: The total number of shares of all classes of stock which the corporation shall have authority to issue is Twenty-nine Million (29,000,000) consisting of two classes of shares designated as follows;

A. Twenty-eight Million (28,000,000) shares of Common Stock, \$.01 par value (the "Common Stock"), and

B. One Million (1,000,000) shares of Preferred Stock, \$.01 par value (the "Preferred Stock").

11.DEC.2000 15:31

ELECTRIC FUEL LTD 972 2 9906688

STATE OF DELAWARE
NOTARY PUBLIC
SECRETARY OF STATE
DIVISION OF CORPORATIONS
FILED 09:00 AM 12/11/2000
001621072 - 2249957

STATE OF DELAWARE

CERTIFICATE OF AMENDMENT OF THE AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF ELECTRIC FUEL CORPORATION

Adopted in accordance with the provisions of
Section 242 of the General Corporation Law
of the State of Delaware

The undersigned, being respectively the President and Secretary of Electric Fuel Corporation, a corporation existing under the laws of the State of Delaware (the "Corporation"), hereby certify as follows:

FIRST: Article FOUR of the certificate of incorporation of the Corporation, as heretofore amended and restated (the "Certificate of Incorporation"), authorizes the issuance of twenty-nine million (29,000,000) shares of capital stock, \$.01 par value, of which twenty-eight million (28,000,000) shares were designated common stock and one million (1,000,000) shares were designated preferred stock.

SECOND: In order to increase the number of shares of capital stock that the Corporation shall be authorized to issue, the Certificate of Incorporation is hereby amended as follows:

By striking out Article FOUR as it now exists and inserting in lieu and instead thereof a new Article FOUR reading in its entirety as follows:

FOUR: The total number of shares of all classes of stock that the Corporation shall have authority to issue is one hundred-one million (101,000,000) consisting of two classes of shares designated as follows:

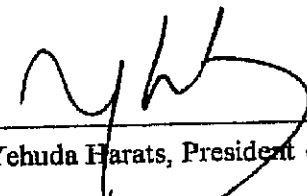
A: One hundred million (100,000,000) shares of Common Stock, \$.01 par value (the "Common Stock"); and

B. One million (1,000,000) shares of Preferred Stock, \$.01 par value (the "Preferred Stock").

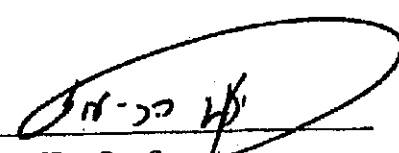
THIRD: This amendment has been duly adopted at a meeting of the Board of Directors of the Corporation and at a meeting of the stockholders of the Corporation duly called and held, pursuant to notice in accordance with Section 222 of the General Corporation Law, by the vote of the holders of a majority of the outstanding stock of the Corporation entitled to vote thereon in accordance with the provisions of Section 242 of the General Corporation Law.

FOURTH: The capital of the Corporation shall not be reduced under or by reason of this amendment.

IN WITNESS WHEREOF, the undersigned have executed this Certificate this 11th day of December, 2000.


Yehuda Harats, President & CEO

ATTEST:


Yaakov Har-Oz, Secretary

STATE OF DELAWARE

CERTIFICATE OF AMENDMENT

OF THE

AMENDED AND RESTATED

CERTIFICATE OF INCORPORATION

OF

ELECTRIC FUEL CORPORATION

Adopted in accordance with the provisions of
Section 242 of the General Corporation Law
of the State of Delaware

The undersigned, being respectively the Chairman and Secretary of Electric Fuel Corporation, a corporation existing under the laws of the State of Delaware (the "Corporation"), hereby certify as follows:

FIRST: The certificate of incorporation of the Corporation, as heretofore amended and restated (the "Certificate of Incorporation"), is hereby amended as follows:

By striking out Article ONE of the Certificate of Incorporation as it now exists and inserting in lieu and instead thereof a new Article ONE, reading in its entirety as follows:

ONE: The name of this corporation is Arotech Corporation.

SECOND: This amendment has been duly adopted at a meeting of the Board of Directors of the Corporation and at a meeting of the stockholders of the Corporation duly called and held, pursuant to notice in accordance with Section 222 of the General Corporation Law, by

the vote of the holders of a majority of the outstanding stock of the Corporation entitled to vote thereon in accordance with the provisions of Section 242 of the General Corporation Law.

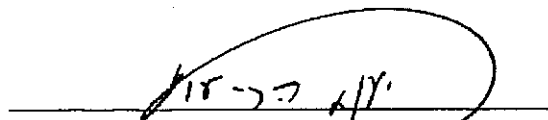
THIRD: The capital of the Corporation shall not be reduced under or by reason of this amendment.

IN WITNESS WHEREOF, the undersigned have executed this Certificate this 16th day of September, 2003.



Robert S. Ehrlich, Chairman and CEO

ATTEST:



Yaakov Har-Oz, Secretary

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Exhibit 3.1.1

STATE OF DELAWARE
 CERTIFICATE OF AMENDMENT
 OF THE
 AMENDED AND RESTATED
 CERTIFICATE OF INCORPORATION
 OF
 ELECTRIC FUEL CORPORATION

 Adopted in accordance with the provisions of
 Section 242 of the General Corporation Law
 of the State of Delaware

The undersigned, being respectively the President and Secretary of Electric Fuel Corporation, a corporation existing under the laws of the State of Delaware (the "Corporation"), hereby certify as follows:

FIRST: Article FOUR of the certificate of incorporation of the Corporation, as heretofore amended and restated (the "Certificate of Incorporation"), authorizes the issuance of twenty-nine million (29,000,000) shares of capital stock, \$.01 par value, of which twenty-eight million (28,000,000) shares were designated common stock and one million (1,000,000) shares were designated preferred stock.

SECOND: In order to increase the number of shares of capital stock that the Corporation shall be authorized to issue, the Certificate of Incorporation is hereby amended as follows:

By striking out Article FOUR as it now exists and inserting in lieu and instead thereof a new Article FOUR reading in its entirety as follows:

FOUR: The total number of shares of all classes of

stock that the Corporation shall have authority to issue is one hundred-one million (101,000,000) consisting of two classes of shares designated as follows:

A: One hundred million (100,000,000) shares of Common Stock, \$.01 par value (the "Common Stock"); and

<PAGE>

- 2 -

B. One million (1,000,000) shares of Preferred Stock, \$.01 par value (the "Preferred Stock").

THIRD: This amendment has been duly adopted at a meeting of the Board of Directors of the Corporation and at a meeting of the stockholders of the Corporation duly called and held, pursuant to notice in accordance with Section 222 of the General Corporation Law, by the vote of the holders of a majority of the outstanding stock of the Corporation entitled to vote thereon in accordance with the provisions of Section 242 of the General Corporation Law.

FOURTH: The capital of the Corporation shall not be reduced under or by reason of this amendment.

IN WITNESS WHEREOF, the undersigned have executed this Certificate this 11/th/ day of December, 2000.

/s/ Yehuda Harats

Yehuda Harats, President

ATTEST:

/s/ Yaakov Har-Oz

Yaakov Har-Oz, Secretary

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Exhibit 3.1.3

STATE OF DELAWARE

CERTIFICATE OF AMENDMENT

OF THE

AMENDED AND RESTATED

CERTIFICATE OF INCORPORATION

OF

ELECTRIC FUEL CORPORATION

Adopted in accordance with the provisions of
Section 242 of the General Corporation Law
of the State of Delaware

The undersigned, being respectively the Chairman and Secretary of Electric Fuel Corporation, a corporation existing under the laws of the State of Delaware (the "Corporation"), hereby certify as follows:

FIRST: The certificate of incorporation of the Corporation, as heretofore amended and restated (the "Certificate of Incorporation"), is hereby amended as follows:

By striking out Article ONE of the Certificate of Incorporation as it now exists and inserting in lieu and instead thereof a new Article ONE, reading in its entirety as follows:

ONE: The name of this corporation is Arotech Corporation.

SECOND: This amendment has been duly adopted at a meeting of the Board of Directors of the Corporation and at a meeting of the stockholders of the Corporation duly called and held, pursuant to notice in accordance with Section 222 of the General Corporation Law, by the vote of the holders of a majority of the outstanding stock of the Corporation entitled to vote thereon in accordance with the provisions of Section 242 of the General Corporation Law.

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THIRD: The capital of the Corporation shall not be reduced under or by reason of this amendment.

IN WITNESS WHEREOF, the undersigned have executed this Certificate this 16th day of September, 2003.

Robert S. Ehrlich, Chairman and CEO

ATTEST:

Yaakov Har-Oz, Secretary

2

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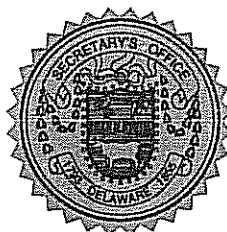
Delaware

PAGE 1

The First State

I, HARRIET SMITH WINDSOR, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY THE ATTACHED IS A TRUE AND CORRECT COPY OF THE CERTIFICATE OF AMENDMENT OF "AROTECH CORPORATION", FILED IN THIS OFFICE ON THE SIXTEENTH DAY OF JUNE, A.D. 2004, AT 11:24 O'CLOCK A.M.

A FILED COPY OF THIS CERTIFICATE HAS BEEN FORWARDED TO THE KENT COUNTY RECORDER OF DEEDS.



2249957 8100

040443684

Harriet Smith Windsor

Harriet Smith Windsor, Secretary of State

AUTHENTICATION: 3176326

DATE: 06-17-04

STATE OF DELAWARE

CERTIFICATE OF AMENDMENT

OF THE

AMENDED AND RESTATED

CERTIFICATE OF INCORPORATION

OF

AROTECH CORPORATION

Adopted in accordance with the provisions of
Section 242 of the General Corporation Law
of the State of Delaware

The undersigned, being respectively the Chairman and Secretary of Arotech Corporation, a corporation existing under the laws of the State of Delaware (the "Corporation"), hereby certify as follows:

FIRST: Article FOUR of the certificate of incorporation of the Corporation, as heretofore amended and restated (the "Certificate of Incorporation"), authorizes the issuance of one hundred one million (101,000,000) shares of capital stock, \$.01 par value, of which one hundred million (100,000,000) shares were designated common stock and one million (1,000,000) shares were designated preferred stock.

SECOND: In order to increase the number of shares of capital stock that the Corporation shall be authorized to issue, the Certificate of Incorporation is hereby amended as follows:

By striking out Article FOUR as it now exists and inserting in lieu and instead thereof a new Article FOUR reading in its entirety as follows:

FOUR: The total number of shares of all classes of stock that the Corporation shall have authority to issue is two hundred fifty-one million (251,000,000) consisting of two classes of shares designated as follows:

A: Two hundred fifty million (250,000,000) shares of Common Stock, \$.01 par value (the "Common Stock"); and

B. One million (1,000,000) shares of Preferred Stock, \$.01 par value (the "Preferred Stock").

THIRD: This amendment has been duly adopted at a meeting of the Board of Directors of the Corporation and at a meeting of the stockholders of the Corporation duly called and held, pursuant to notice in accordance with Section 222 of the General Corporation Law, by the vote of the holders of a majority of the outstanding stock of the Corporation entitled to vote thereon in accordance with the provisions of Section 242 of the General Corporation Law.

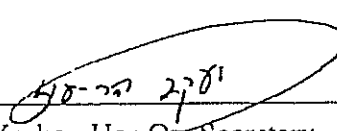
FOURTH: The capital of the Corporation shall not be reduced under or by reason of this amendment.

IN WITNESS WHEREOF, the undersigned have executed this Certificate this 16th day of June, 2004.



Robert S. Ehrlich, Chairman

ATTEST:



Yaakov Har-Oz, Secretary

STATE OF DELAWARE

CERTIFICATE OF AMENDMENT

OF THE

AMENDED AND RESTATED

CERTIFICATE OF INCORPORATION

OF

AROTECH CORPORATION

Adopted in accordance with the provisions of
Section 242 of the General Corporation Law
of the State of Delaware

The undersigned, being respectively the Chairman and Secretary of Arotech Corporation, a corporation existing under the laws of the State of Delaware (the "Corporation"), hereby certify as follows:

FIRST: In order to effect a one-for-fourteen reverse split of the Company's outstanding common stock, the Certificate of Incorporation is hereby amended as follows:

By striking out Article FOUR as it now exists and inserting in lieu and instead thereof a new Article FOUR reading in its entirety as follows:

FOUR: 1. The total number of shares of all classes of stock that the Corporation shall have authority to issue is two hundred fifty-one million (251,000,000) consisting of two classes of shares designated as follows:

A. Two hundred fifty million (250,000,000) shares of Common Stock, \$.01 par value (the "Common Stock"); and

B. One million (1,000,000) shares of Preferred Stock, \$.01 par value (the "Preferred Stock").

2. Conversion of Common Stock. At the time of the filing of this amendment to our Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware, (a) each fourteen (14) shares of issued and outstanding common stock shall automatically, without the necessity of any further action on the part of the holder thereof, be changed and reclassified into one (1) share of common stock. Upon the occurrence of the reclassification effected by this Article Four, Section 2 (the "Conversion"), each certificate for outstanding shares of common stock dated prior to the effective date of the Conversion ("Old Common Stock") shall evidence, and be deemed to evidence, the number of shares of common stock into which the shares previously evidenced by such certificate shall have been reclassified in accordance with this Article Four, Section 2, and the Conversion shall become effective in accordance with the terms hereof, whether or not any or all of the certificates evidencing Old Common Stock shall have been surrendered or new certificates evidencing the number of shares of common stock into which such shares have been reclassified have been issued in accordance with Article Four, Section 3 hereof.

3. Subsequent Reissuance of Certificates. Following the occurrence of the Conversion, each holder of shares of Old Common Stock shall be sent a letter of transmittal from the Corporation's transfer agent and shall either (a) surrender each certificate evidencing any such shares pursuant to the instructions in such letter of transmittal or (b) notify the Corporation that such certificate has been lost, stolen or destroyed and execute an agreement satisfactory to the Corporation and its transfer agent to indemnify the Corporation and its transfer agent from any loss incurred by it in connection with the reissuance of such lost, stolen or destroyed certificate. The Corporation shall thereupon issue and deliver or cause to be issued and delivered to such holder a certificate or certificates, in the name shown on such certificate evidencing Old Common Stock, for the number of whole shares of common stock into which the shares of Old Common Stock evidenced by the surrendered (or lost, stolen or destroyed) certificate have been reclassified, dated as of the date on which the Conversion become effective. The Corporation shall not be obligated to issue any certificate evidencing shares of common stock in connection with the Conversion except in accordance with this Article Four, Section 3.

4. Fractional Shares. Notwithstanding the foregoing, no fraction of a share of common stock shall be issued by virtue of the Conversion, but in lieu thereof, each holder of shares of Old Common Stock who would otherwise be entitled to a

fraction of a share of common stock (after aggregating all fractional shares of Common Stock to be received by such holder) shall receive from the Corporation the number of shares of common stock the holder would otherwise be entitled to, rounded down to the next number of whole shares of common stock.

5. Par Value of Common Stock. The par value of the Common Stock as set forth in Article Four, Section 1A hereof shall remain unchanged by the Conversion.

SECOND: This amendment has been duly adopted at a meeting of the Board of Directors of the Corporation and at a meeting of the stockholders of the Corporation duly called and held, pursuant to notice in accordance with Section 222 of the General Corporation Law, by the vote of the holders of a majority of the outstanding stock of the Corporation entitled to vote thereon in accordance with the provisions of Section 242 of the General Corporation Law.

THIRD: The capital of the Corporation shall not be reduced under or by reason of this amendment.

FOURTH: This Amendment shall be effective at 7:00 a.m. Eastern Daylight Time on June 21, 2006.

IN WITNESS WHEREOF, the undersigned have executed this Certificate this 20th day of June, 2006.

/s/ Robert S. Ehrlich
Robert S. Ehrlich, Chairman

ATTEST:

/s/ Yaakov Har-Oz
Yaakov Har-Oz, Secretary

BY-LAWS
OF
ELECTRIC FUEL CORPORATION

Section 1. LAW, CERTIFICATE OF INCORPORATION AND BY-LAWS

1.1. These by-laws are subject to the certificate of incorporation of the corporation. In these by-laws, references to law, the certificate of incorporation and by-laws mean the law, the provisions of the certificate of incorporation and the by-laws as from time to time in effect.

Section 2. STOCKHOLDERS

2.1. Annual Meeting. The annual meeting of stockholders shall be held at such date, time and place as shall be designated from time to time by the board of directors and stated in the notice of the meeting, at which they shall elect a board of directors and transact such other business as may be required by law or these by-laws or as may properly come before the meeting.

2.2. Special Meetings. A special meeting of the stockholders may be called at any time by the chairman of the board, if any, the president or the board of directors. A special meeting of the stockholders shall be called by the secretary, or in the case of the death, absence, incapacity or refusal of the secretary, by an assistant secretary or some other officer, upon application of a majority of the directors. Any such application shall state the purpose or purposes of the proposed meeting. Any such call shall state the place, date, hour, and purposes of the meeting.

2.3. Place of Meeting. All meetings of the stockholders for the election of directors or for any other purpose shall be held at such place within or without the State of Delaware as may be determined from time to time by the chairman of the board, if any, the president or the board of directors. Any adjourned session of any meeting of the stockholders shall be held at the place designated in the vote of adjournment.

2.4. Notice of Meetings. Except as otherwise provided by law, a written notice of each meeting of stockholders stating the place, day and hour thereof and, in the case of a special meeting, the purposes for which the meeting is called, shall be given not less than ten nor more than sixty days before the meeting, to each stockholder entitled to vote thereat, and to each stockholder who, by law, by the certificate of incorporation or by these by-laws, is entitled to notice, by leaving such notice with him or at his residence or usual place of business, or by depositing it in the United States mail, postage prepaid, and addressed to such stockholder at his address as it appears in the records of the corporation. Such notice shall be

given by the secretary, or by an officer or person designated by the board of directors, or in the case of a special meeting by the officer calling the meeting. As to any adjourned session of any meeting of stockholders, notice of the adjourned meeting need not be given if the time and place thereof are announced at the meeting at which the adjournment was taken except that if the adjournment is for more than thirty days or if after the adjournment a new record date is set for the adjourned session, notice of any such adjourned session of the meeting shall be given in the manner heretofore described. No notice of any meeting of stockholders or any adjourned session thereof need be given to a stockholder if a written waiver of notice, executed before or after the meeting or such adjourned session by such stockholder, is filed with the records of the meeting or if the stockholder attends such meeting without objecting at the beginning of the meeting to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any meeting of the stockholders or any adjourned session thereof need be specified in any written waiver of notice.

2.5. Quorum of Stockholders. At any meeting of the stockholders a quorum as to any matter shall consist of a majority of the votes entitled to be cast on the matter, except where a larger quorum is required by law, by the certificate of incorporation or by these by-laws. Any meeting may be adjourned from time to time by a majority of the votes properly cast upon the question, whether or not a quorum is present. If a quorum is present at an original meeting, a quorum need not be present at an adjourned session of that meeting. Shares of its own stock belonging to the corporation or to another corporation, if a majority of the shares entitled to vote in the election of directors of such other corporation is held, directly or indirectly, by the corporation, shall neither be entitled to vote nor be counted for quorum purposes; provided, however, that the foregoing shall not limit the right of any corporation to vote stock, including but not limited to its own stock, held by it in a fiduciary capacity.

2.6. Action by Vote. When a quorum is present at any meeting, a plurality of the votes properly cast for election to any office shall elect to such office and a majority of the votes properly cast upon any question other than an election to an office shall decide the question, except when a larger vote is required by law, by the certificate of incorporation or by these by-laws. No ballot shall be required for any election unless requested by a stockholder present or represented at the meeting and entitled to vote in the election.

2.7. Action without Meetings. Unless otherwise provided in the certificate of incorporation, any action required or permitted to be taken by stockholders for or in connection with any corporate action may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting forth the action so taken, shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted and shall be delivered to the corporation by

delivery to its registered office in Delaware by hand or certified or registered mail, return receipt requested, to its principal place of business or to an officer or agent of the corporation having custody of the book in which proceedings of meetings of stockholders are recorded. Each such written consent shall bear the date of signature of each stockholder who signs the consent. No written consent shall be effective to take the corporate action referred to therein unless written consents signed by a number of stockholders sufficient to take such action are delivered to the corporation in the manner specified in this paragraph within sixty days of the earliest dated consent so delivered.

If action is taken by consent of stockholders and in accordance with the foregoing, there shall be filed with the records of the meetings of stockholders the writing or writings comprising such consent.

If action is taken by less than unanimous consent of stockholders, prompt notice of the taking of such action without a meeting shall be given to those who have not consented in writing and a certificate signed and attested to by the secretary that such notice was given shall be filed with the records of the meetings of stockholders.

In the event that the action which is consented to is such as would have required the filing of a certificate under any provision of the General Corporation Law of the State of Delaware, if such action had been voted upon by the stockholders at a meeting thereof, the certificate filed under such provision shall state, in lieu of any statement required by such provision concerning a vote of stockholders, that written consent has been given under Section 228 of said General Corporation Law and that written notice has been given as provided in such Section 228.

2.8. Proxy Representation. Every stockholder may authorize another person or persons to act for him by proxy in all matters in which a stockholder is entitled to participate, whether by waiving notice of any meeting, objecting to or voting or participating at a meeting, or expressing consent or dissent without a meeting. Every proxy must be signed by the stockholder or by his attorney-in-fact. No proxy shall be voted or acted upon after three years from its date unless such proxy provides for a longer period. A duly executed proxy shall be irrevocable if it states that it is irrevocable and, if, and only as long as, it is coupled with an interest sufficient in law to support an irrevocable power. A proxy may be made irrevocable regardless of whether the interest with which it is coupled is an interest in the stock itself or an interest in the corporation generally. The authorization of a proxy may but need not be limited to specified action, provided, however, that if a proxy limits its authorization to a meeting or meetings of stockholders, unless otherwise specifically provided such proxy shall entitle the holder thereof to vote at any adjourned session but shall not be valid after the final adjournment thereof.

2.9. Inspectors. The directors or the person presiding at the meeting may, but need not, appoint one or more inspectors of election and any substitute inspectors to act at the meeting or any adjournment thereof. Each inspector, before entering upon the discharge of his duties, shall take and sign an oath faithfully to execute the duties of inspector at such meeting with strict impartiality and according to the best of his ability. The inspectors, if any, shall determine the number of shares of stock outstanding and the voting power of each, the shares of stock represented at the meeting, the existence of a quorum, the validity and effect of proxies, and shall receive votes, ballots or consents, hear and determine all challenges and questions arising in connection with the right to vote, count and tabulate all votes, ballots or consents, determine the result, and do such acts as are proper to conduct the election or vote with fairness to all stockholders. On request of the person presiding at the meeting, the inspectors shall make a report in writing of any challenge, question or matter determined by them and execute a certificate of any fact found by them.

2.10. List of Stockholders. The secretary shall prepare and make, at least ten days before every meeting of stockholders, a complete list of the stockholders entitled to vote at such meeting, arranged in alphabetical order and showing the address of each stockholder and the number of shares registered in his name. The stock ledger shall be the only evidence as to who are stockholders entitled to examine such list or to vote in person or by proxy at such meeting.

Section 3. BOARD OF DIRECTORS

3.1. Number. The number of directors which shall constitute the whole board shall not be less than 3 nor more than the maximum number allowed by law. Thereafter, within the foregoing limits, the stockholders at the annual meeting shall determine the number of directors and shall elect the number of directors as determined. Within the foregoing limits, the number of directors may be increased at any time or from time to time by the stockholders or by the directors by vote of a majority of the directors then in office. The number of directors may be decreased to any number permitted by the foregoing at any time either by the stockholders or by the directors by vote of a majority of the directors then in office, but only to eliminate vacancies existing by reason of the death, resignation or removal of one or more directors. Directors need not be stockholders.

3.2. Tenure. Except as otherwise provided by law, by the certificate of incorporation or by these by-laws, each director shall hold office until the next annual meeting and until his successor is elected and qualified, or until he sooner dies, resigns, is removed or becomes disqualified.

3.3. Powers. The business and affairs of the corporation shall be managed by or under the direction of the board of directors who shall have and may exercise all the powers of

the corporation and do all such lawful acts and things as are not by law, the certificate of incorporation or these by-laws directed or required to be exercised or done by the stockholders.

3.4. Vacancies. Vacancies and any newly created directorships resulting from any increase in the number of directors may be filled by vote of the stockholders at a meeting called for the purpose, or by a majority of the directors then in office, although less than a quorum, or by a sole remaining director. When one or more directors shall resign from the board, effective at a future date, a majority of the directors then in office, including those who have resigned, shall have power to fill such vacancy or vacancies, the vote or action by writing thereon to take effect when such resignation or resignations shall become effective. The directors shall have and may exercise all their powers notwithstanding the existence of one or more vacancies in their number, subject to any requirements of law or of the certificate of incorporation or of these by-laws as to the number of directors required for a quorum or for any vote or other actions.

3.5. Committees. The board of directors may, by vote of a majority of the whole board, (a) designate, change the membership of or terminate the existence of any committee or committees, each committee to consist of one or more of the directors; (b) designate one or more directors as alternate members of any such committee who may replace any absent or disqualified member at any meeting of the committee; and (c) determine the extent to which each such committee shall have and may exercise the powers of the board of directors in the management of the business and affairs of the corporation, including the power to authorize the seal of the corporation to be affixed to all papers which require it and the power and authority to declare dividends or to authorize the issuance of stock; excepting, however, such powers which by law, by the certificate of incorporation or by these by-laws they are prohibited from so delegating. In the absence or disqualification of any member of such committee and his alternate, if any, the member or members thereof present at any meeting and not disqualified from voting, whether or not constituting a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Except as the board of directors may otherwise determine, any committee may make rules for the conduct of its business, but unless otherwise provided by the board or such rules, its business shall be conducted as nearly as may be in the same manner as is provided by these by-laws for the conduct of business by the board of directors. Each committee shall keep regular minutes of its meetings and report the same to the board of directors upon request.

3.6. Regular Meetings. Regular meetings of the board of directors may be held without call or notice at such places within or without the State of Delaware and at such times as the board may from time to time determine, provided that notice of the first regular meeting following any such determination shall be given to absent directors. A regular meeting of the

directors may be held without call or notice immediately after and at the same place as the annual meeting of stockholders.

3.7. Special Meetings. Special meetings of the board of directors may be held at any time and at any place within or without the State of Delaware designated in the notice of the meeting, when called by the chairman of the board, if any, the president, or by one-third or more in number of the directors, reasonable notice thereof being given to each director by the secretary or by the chairman of the board, if any, the president or any one of the directors calling the meeting.

3.8. Notice. It shall be reasonable and sufficient notice to a director to send notice by mail at least forty-eight hours or by telegram at least twenty-four hours before the meeting addressed to him at his usual or last known business or residence address or to give notice to him in person or by telephone at least twenty-four hours before the meeting. Notice of a meeting need not be given to any director if a written waiver of notice, executed by him before or after the meeting, is filed with the records of the meeting, or to any director who attends the meeting without protesting prior thereto or at its commencement the lack of notice to him. Neither notice of a meeting nor a waiver of a notice need specify the purposes of the meeting.

3.9. Quorum. Except as may be otherwise provided by law, by the certificate of incorporation or by these by-laws, at any meeting of the directors a majority of the directors then in office shall constitute a quorum; a quorum shall not in any case be less than one-third of the total number of directors constituting the whole board. Any meeting may be adjourned from time to time by a majority of the votes cast upon the question, whether or not a quorum is present, and the meeting may be held as adjourned without further notice.

3.10. Action by Vote. Except as may be otherwise provided by law, by the certificate of incorporation or by these by-laws, when a quorum is present at any meeting the vote of a majority of the directors present shall be the act of the board of directors.

3.11. Action Without a Meeting. Any action required or permitted to be taken at any meeting of the board of directors or a committee thereof may be taken without a meeting if all the members of the board or of such committee, as the case may be, consent thereto in writing, and such writing or writings are filed with the records of the meetings of the board or of such committee. Such consent shall be treated for all purposes as the act of the board or of such committee, as the case may be.

3.12. Participation in Meetings by Conference Telephone. Members of the board of directors, or any committee designated by such board, may participate in a meeting of such board or committee by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other or by any other

means permitted by law. Such participation shall constitute presence in person at such meeting.

3.13. Compensation. In the discretion of the board of directors, each director may be paid such fees for his services as director and be reimbursed for his reasonable expenses incurred in the performance of his duties as director as the board of directors from time to time may determine. Nothing contained in this section shall be construed to preclude any director from serving the corporation in any other capacity and receiving reasonable compensation therefor.

3.14. Interested Directors and Officers.

(a) No contract or transaction between the corporation and one or more of its directors or officers, or between the corporation and any other corporation, partnership, association, or other organization in which one or more of the corporation's directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the stockholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

Section 4. OFFICERS AND AGENTS

4.1. Enumeration: Qualification. The officers of the corporation shall be a president, a treasurer, a secretary and such other officers, if any, as the board of directors from time to time may in its discretion elect or appoint including without limitation a chairman of the board, one or more vice presidents and a controller. The corporation may also have such agents, if any, as the board of directors from time to time may in its discretion choose. Any officer may be but none need be a director or stockholder. Any two or more offices may be held by the same person. Any officer may be required by the board of directors to secure the faithful performance of his duties to the corporation by giving bond in such amount and with sureties or otherwise as the board of directors may determine.

4.2. Powers. Subject to law, to the certificate of incorporation and to the other provisions of these by-laws, each officer shall have, in addition to the duties and powers herein set forth, such duties and powers as are commonly incident to his office and such additional duties and powers as the board of directors may from time to time designate.

4.3. Election. The officers may be elected by the board of directors at their first meeting following the annual meeting of the stockholders or at any other time. At any time or from time to time the directors may delegate to any officer their power to elect or appoint any other officer or any agents.

4.4. Tenure. Each officer shall hold office until the first meeting of the board of directors following the next annual meeting of the stockholders and until his respective successor is chosen and qualified unless a shorter period shall have been specified by the terms of his election or appointment, or in each case until he sooner dies, resigns, is removed or becomes disqualified. Each agent shall retain his authority at the pleasure of the directors, or the officer by whom he was appointed or by the officer who then holds agent appointive power.

4.5. Chairman of the Board of Directors, President and Vice President. The chairman of the board, if any, shall have such duties and powers as shall be designated from time to time by the board of directors. Unless the board of directors otherwise specifies, the chairman of the board, or if there is none the chief executive officer, shall preside, or designate the person who shall preside, at all meetings of the stockholders and of the board of directors.

Unless the board of directors otherwise specifies, the president shall be the chief executive officer and shall have direct charge of all business operations of the corporation and, subject to the control of the directors, shall have general charge and supervision of the business of the corporation.

Any vice presidents shall have such duties and powers as shall be set forth in these by-laws or as shall be designated from time to time by the board of directors or by the president.

4.6. Treasurer and Assistant Treasurers. Unless the board of directors otherwise specifies, the treasurer shall be the chief financial officer of the corporation and shall be in charge of its funds and valuable papers, and shall have such other duties and powers as may be designated from time to time by the board of directors or by the president. If no controller is elected, the treasurer shall, unless the board of directors otherwise specifies, also have the duties and powers of the controller.

Any assistant treasurers shall have such duties and powers as shall be designated from time to time by the board of directors, the president or the treasurer.

4.7. Controller and Assistant Controllers. If a controller is elected, he shall, unless the board of directors otherwise specifies, be the chief accounting officer of the corporation and be in charge of its books of account and accounting records, and of its accounting procedures. He shall have such other duties and powers as may be designated from time to time by the board of directors, the president or the treasurer.

Any assistant controller shall have such duties and powers as shall be designated from time to time by the board of directors, the president, the treasurer or the controller.

4.8. Secretary and Assistant Secretaries. The secretary shall record all proceedings of the stockholders, of the board of directors and of committees of the board of directors in a book or series of books to be kept therefor and shall file therein all actions by written consent of stockholders or directors. In the absence of the secretary from any meeting, an assistant secretary, or if there be none or he is absent, a temporary secretary chosen at the meeting, shall record the proceedings thereof. Unless a transfer agent has been appointed the secretary shall keep or cause to be kept the stock and transfer records of the corporation, which shall contain the names and record addresses of all stockholders and the number of shares registered in the name of each stockholder. He shall have such other duties and powers as may from time to time be designated by the board of directors or the president.

Any assistant secretaries shall have such duties and powers as shall be designated from time to time by the board of directors, the president or the secretary.

Section 5. RESIGNATIONS AND REMOVALS

5.1. Any director or officer may resign at any time by delivering his resignation in writing to the chairman of the board, if any, the president, or the secretary or to a meeting of the board of directors. Such resignation shall be effective upon receipt unless specified to be

effective at some other time, and without in either case the necessity of its being accepted unless the resignation shall so state. Except as otherwise provided by law, or in the certificate of incorporation, a director (including persons elected by directors to fill vacancies in the board) may be removed from office with or without cause by the vote of the holders of a majority of the shares issued and outstanding and entitled to vote in the election of directors. The board of directors may at any time remove any officer either with or without cause. The board of directors may at any time terminate or modify the authority of any agent. No director or officer resigning and (except where a right to receive compensation shall be expressly provided in a duly authorized written agreement with the corporation) no director or officer removed shall have any right to any compensation as such director or officer for any period following his resignation or removal, or any right to damages on account of such removal, whether his compensation be by the month or by the year or otherwise; unless, in the case of a resignation, the directors, or, in the case of removal, the body acting on the removal, shall in their or its discretion provide for compensation.

Section 6. VACANCIES

6.1. If the office of the president or the treasurer or the secretary becomes vacant, the directors may elect a successor by vote of a majority of the directors then in office. If the office of any other officer becomes vacant, any person or body empowered to elect or appoint that officer may choose a successor. Each such successor shall hold office for the unexpired term, and in the case of the president, the treasurer and the secretary until his successor is chosen and qualified or in each case until he sooner dies, resigns, is removed or becomes disqualified. Any vacancy of a directorship shall be filled as specified in Section 3.4 of these by-laws.

Section 7. CAPITAL STOCK

7.1. Stock Certificates. Each stockholder shall be entitled to a certificate stating the number and the class and the designation of the series, if any, of the shares held by him, in such form as shall, in conformity to law, the certificate of incorporation and the by-laws, be prescribed from time to time by the board of directors. Such certificate shall be signed by the chairman or vice chairman of the board, if any, or the president or a vice president and by the treasurer or an assistant treasurer or by the secretary or an assistant secretary. Any or all of the signatures on the certificate may be a facsimile. In case an officer, transfer agent, or registrar who has signed or whose facsimile signature has been placed on such certificate shall have ceased to be such officer, transfer agent, or registrar before such certificate is issued, it may be issued by the corporation with the same effect as if he were such officer, transfer agent, or registrar at the time of its issue.

7.2. Loss of Certificates. In the case of the alleged theft, loss, destruction or mutilation of a certificate of stock, a duplicate certificate may be issued in place thereof, upon such terms, including receipt of a bond sufficient to indemnify the corporation against any claim on account thereof, as the board of directors may prescribe.

Section 8. TRANSFER OF SHARES OF STOCK

8.1. Transfer on Books. Subject to the restrictions, if any, stated or noted on the stock certificate, shares of stock may be transferred on the books of the corporation by the surrender to the corporation or its transfer agent of the certificate therefor properly endorsed or accompanied by a written assignment and power of attorney properly executed, with necessary transfer stamps affixed, and with such proof of the authenticity of signature as the board of directors or the transfer agent of the corporation may reasonably require. Except as may be otherwise required by law, by the certificate of incorporation or by these by-laws, the corporation shall be entitled to treat the record holder of stock as shown on its books as the owner of such stock for all purposes, including the payment of dividends and the right to receive notice and to vote or to give any consent with respect thereto and to be held liable for such calls and assessments, if any, as may lawfully be made thereon, regardless of any transfer, pledge or other disposition of such stock until the shares have been properly transferred on the books of the corporation.

It shall be the duty of each stockholder to notify the corporation of his post office address.

8.2. Record Date and Closing Transfer Books. In order that the corporation may determine the stockholders entitled to notice of or to vote at any meeting of stockholders or any adjournment thereof, the board of directors may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is adopted by the board of directors, and which record date shall not be more than sixty nor less than ten days before the date of such meeting. If no such record date is fixed by the board of directors, the record date for determining the stockholders entitled to notice of or to vote at a meeting of stockholders shall be at the close of business on the day next preceding the day on which notice is given, or, if notice is waived, at the close of business on the day next preceding the day on which the meeting is held. A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; provided, however, that the board of directors may fix a new record date for the adjourned meeting.

In order that the corporation may determine the stockholders entitled to consent to corporate action in writing without a meeting, the board of directors may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is

adopted by the board of directors, and which date shall not be more than ten days after the date upon which the resolution fixing the record date is adopted by the board of directors. If no such record date has been fixed by the board of directors, the record date for determining stockholders entitled to consent to corporate action in writing without a meeting, when no prior action by the board of directors is required by the General Corporation Law of the State of Delaware, shall be the first date on which a signed written consent setting forth the action taken or proposed to be taken is delivered to the corporation by delivery to its registered office in Delaware by hand or certified or registered mail, return receipt requested, to its principal place of business or to an officer or agent of the corporation having custody of the book in which proceedings of meetings of stockholders are recorded. If no record date has been fixed by the board of directors and prior action by the board of directors is required by the General Corporation Law of the State of Delaware, the record date for determining stockholders entitled to consent to corporate action in writing without a meeting shall be at the close of business on the day on which the board of directors adopts the resolution taking such prior action.

In order that the corporation may determine the stockholders entitled to receive payment of any dividend or other distribution or allotment of any rights or to exercise any rights in respect of any change, conversion or exchange of stock, or for the purpose of any other lawful action, the board of directors may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is adopted, and which record date shall be not more than sixty days prior to such payment, exercise or other action. If no such record date is fixed, the record date for determining stockholders for any such purpose shall be at the close of business on the day on which the board of directors adopts the resolution relating thereto.

Section 9. CORPORATE SEAL

9.1. Subject to alteration by the directors, the seal of the corporation shall consist of a flat-faced circular die with the word "Delaware" and the name of the corporation cut or engraved thereon, together with such other words, dates or images as may be approved from time to time by the directors.

Section 10. EXECUTION OF PAPERS

10.1. Except as the board of directors may generally or in particular cases authorize the execution thereof in some other manner, all deeds, leases, transfers, contracts, bonds, notes, checks, drafts or other obligations made, accepted or endorsed by the corporation shall be signed by the chairman of the board, if any, the president, a vice president or the treasurer.

Section 11. FISCAL YEAR

11.1. The fiscal year of the corporation shall end on the last day of the month of December.

Section 12. AMENDMENTS

12.1. These by-laws may be adopted, amended or repealed by vote of a majority of the directors then in office or by vote of a majority of the stock outstanding and entitled to vote. Any by-law, whether adopted, amended or repealed by the stockholders or directors, may be amended or reinstated by the stockholders or the directors.

COMMON STOCK



PAR VALUE
\$.01 PER SHARE

INCORPORATED UNDER THE LAWS
OF THE STATE OF DELAWARE

COMMON STOCK



PAR VALUE
\$.01 PER SHARE

THIS CERTIFICATE IS TRANSFERABLE
IN NEW YORK CITY

CUSIP 042662 10 4

SEE REVERSE FOR CERTAIN DEFINITIONS

AROTECH

AROTECH CORPORATION

THIS CERTIFIES that

SPECIMEN

is the owner of

FULLY PAID AND NON-ASSESSABLE SHARES OF THE COMMON STOCK OF

AROTECH CORPORATION transferable on the books of the Corporation by the holder hereof in person or by duly authorized attorney upon surrender of this Certificate properly endorsed. This Certificate and the shares represented hereby are issued and shall be subject to all of the provisions of the Certificate of Incorporation and By-Laws of the Corporation, each as from time to time amended (copies of which are on file with the Transfer Agent and Registrar), to all of which the holder by acceptance hereof assents. This Certificate is not valid until countersigned and registered by the Transfer Agent and Registrar.

Witness the facsimile seal of the Corporation and the facsimile signatures of its duly authorized officers:

DATED:

12-22-2001



[Signature]

VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY

CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

AUTHORIZED SIGNATURE

COUNTERSIGNED AND REGISTERED:
AMERICAN STOCK TRANSFER & TRUST COMPANY
(NEW YORK, N.Y.)

TRANSFER AGENT
AND REGISTRAR

The following abbreviations, when used in the inscription on the face of this certificate, shall be construed as though they were written out in full according to applicable laws or regulations:

TEN COM — as tenants in common

TEN ENT — as tenants by the entireties

JT TEN — as joint tenants with right of survivorship and not as tenants in common

UNIF GIFT/TRANS MIN ACT — _____ Custodian _____
(Cust) (Minor)

under Uniform Gifts/Transfers to Minors
Act _____
(State)

Additional abbreviations may also be used though not in the above list.

For Value Received, _____ hereby sell, assign and transfer unto

PLEASE INSERT SOCIAL SECURITY OR OTHER
IDENTIFYING NUMBER OF ASSIGNEE

(PLEASE PRINT OR TYPEWRITE NAME AND ADDRESS, INCLUDING ZIP CODE, OF ASSIGNEE)

_____ Shares
of the capital stock represented by the within Certificate, and do hereby irrevocably constitute
and appoint

_____ Attorney
to transfer the said stock on the books of the within named Corporation with full power of
substitution in the premises.

Dated _____

NOTICE: THE SIGNATURE TO THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE
FACE OF THIS CERTIFICATE IN EVERY PARTICULAR, WITHOUT ALTERATION OR ENLARGEMENT OR ANY
CHANGE WHATEVER.

SIGNATURE(S) GUARANTEED: _____

THE SIGNATURE(S) SHOULD BE GUARANTEED BY AN ELIGIBLE GUARANTOR INSTITUTION
(BANKS, STOCKBROKERS, SAVINGS AND LOAN ASSOCIATIONS AND CREDIT UNIONS WITH
MEMBERSHIP IN AN APPROVED SIGNATURE GUARANTEE MCDALLION PROGRAM), PURSUANT TO
S.E.C. RULE 17Ad-15.

**KEEP THIS CERTIFICATE IN A SAFE PLACE. IF IT IS LOST, STOLEN, MUTILATED OR DESTROYED, THE CORPORATION
WILL REQUIRE A BOND OF INDEMNITY AS A CONDITION TO THE ISSUANCE OF A REPLACEMENT CERTIFICATE.**

EX-5.1 3 v048088_ex5-1.htm

Exhibit 5.1

LOWENSTEIN SANDLER PC
Attorneys at Law

July 24, 2006

Arotech Corporation
1229 Oak Valley Drive
Ann Arbor, Michigan 48108

Gentlemen:

We have acted as counsel to Arotech Corporation, a Delaware corporation (the "Company"), in connection with the registration under the Securities Act of 1933, as amended (the "Act"), of an aggregate of 4,360,721 shares of common stock (the "Shares"), par value \$0.01 per share (the "Common Stock"), of the Company, of which (i) 4,062,500 shares (the "Note Shares") may be issued upon conversion of the Company's currently outstanding senior secured convertible notes due 2008 (the "Notes") and (ii) 298,221 shares (the "Warrant Shares") are issuable upon exercise of currently outstanding warrants (the "Warrants").

As such counsel, we have reviewed the corporate proceedings taken by the Company with respect to the authorization of the issuance of the Shares. We have also examined and relied upon originals or copies of such corporate records, documents, agreements or other instruments of the Company as we have deemed necessary to review. As to all matters of fact (including factual conclusions and characterizations and descriptions of purpose, intention or other state of mind), we have entirely relied upon certifications of officers of the Company, and have assumed, without independent inquiry, the accuracy of those certifications.

We have assumed the genuineness of all signatures, the conformity to the originals of all documents reviewed by us as copies, the authenticity and completeness of all original documents reviewed by us in original or copy form and the legal competence of each individual executing a document. We have also assumed that the registration requirements of the Act and all applicable requirements of state laws regulating the sale of securities will have been duly satisfied.

We further assume that (i) all Note Shares issued will be issued in accordance with the terms of the Notes and (ii) all Warrant Shares issued will be issued in accordance with the terms of the Warrants.

Based upon the foregoing, it is our opinion that (i) the Note Shares will be, when issued as contemplated by the terms of the Notes, validly issued and fully paid and nonassessable and (ii) the Warrant Shares will be, when sold, paid for and issued as contemplated by the terms of the Warrants, validly issued and fully paid and nonassessable.

This opinion is limited to the provisions of the Delaware General Corporation Law.

We hereby consent to the filing of this opinion as an exhibit to the Registration Statement and to the references to this firm under the heading "Legal Matters" in the Prospectus. In giving such consent, we do not thereby admit that we are in the category of persons whose consent is required under Section 7 of the Act.

Very truly yours,

/s/ Lowenstein Sandler PC
LOWENSTEIN SANDLER PC

65 Livingston Avenue

Roseland, New Jersey
07068-1791



Telephone 973.597.2500
Fax 973.597.2200

www.lowenstein.com



EMPLOYMENT AGREEMENT

THIS AGREEMENT is entered into as of the ____ day of October, 1993, by and among Electric Fuel Corporation, a Delaware corporation ("EFC"), and Electric Fuel Limited, an Israeli corporation ("EFL" and together with EFC, the "Companies"), and Mr. _____, Israel I.D. Number _____ (the "Executive").

WHEREAS, the Companies and the Executive now wish to formalize the terms of the Executive's employment in accordance with the terms and conditions of this Agreement;

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

1. Term.

The term of the Executive's employment under this Agreement shall be for the period commencing on the date hereof and ending three (3) years thereafter (the "Initial Term"); provided, however, that the term of this Agreement shall be automatically extended for additional terms of two (2) years each (each, an "Additional Term") upon the end of each of the Initial Term and each Additional Term, unless either the Executive or both Companies shall have given written notice to the other at least one hundred eighty days (180) days prior thereto that the term of this Agreement shall not be so extended.

2. Employment.

- (a) The Executive shall be employed as the [President and Chief Executive Officer] [Chairman of the Board and Chief Financial Officer] of each Company. The Executive shall perform the duties, undertake the responsibilities and exercise the authority customarily performed, undertaken and exercised by persons situated in a similar executive capacity in publicly-held United States corporations. The Executive shall exercise his authority in a reasonable manner and shall report to the Board of Directors of each Company (each a "Board").
- (b) Excluding periods of vacation and sick leave to which the Executive shall be entitled, the Executive agrees to devote the attention and time to the businesses and affairs of the Companies required to discharge the responsibilities assigned to the Executive hereunder. [The Companies acknowledge that the Executive may become an officer or director of other companies, and may undertake other activities, and consent to these other positions and activities so long as these do not interfere in any material manner with the Executive's performance of his duties hereunder and do not constitute a violation of Section 8 hereof.][The Companies acknowledge that the Executive is a director of PSC Inc. and of Fresenius USA, Inc. and may be or become an officer or director of these or other companies. In addition, the Companies acknowledge that the Executive is involved in certain investment banking activities which, together with the above mentioned positions, will consume a portion of his time and require him to travel. The Companies consent to these other positions and activities so long as these do not interfere in any material manner with the Executive's performance of his duties hereunder and do not constitute a violation of Section 8 hereof.] The Executive's duties shall be in the nature of management duties that demand a special level of loyalty and accordingly the Law of Work Hours and Rest - 1951 shall not apply to this Agreement.

) While the Executive is employed by the Companies hereunder, the Companies shall cause the Executive to be elected to, and the Executive shall serve on, each Board as a member of such Board.

) Each Company will use its reasonable best efforts to obtain, and to keep in place at all times the Executive is a director or officer of either Company, a directors and officers liability policy covering the Executive in an amount reasonably deemed satisfactory by the Executive and otherwise containing terms and conditions reasonably deemed satisfactory by the Executive.

Base Salary and Bonus.

) The Companies agree to pay or cause to be paid to the Executive during the term of this Agreement a base salary at the rate of US \$ _____ per month, payable in U.S. Dollars or in the currency of Israel (as determined by the Representative Rate of the U.S. Dollar published by the Bank of Israel immediately prior to the date of payment of each installment thereof), or such larger amount as the Board may from time to time determine (hereinafter referred to as the "Base Salary"). On each anniversary of this Agreement, the Base Salary shall be adjusted in an amount equal to the excess, if any, of any increase in the Israeli Consumer Price Index over any devaluation in currency of Israel compared to the U.S. Dollar, in each case during the year immediately preceding such anniversary. Such Base Salary shall be payable in equal monthly installments.

) The Companies agree to pay or cause to be paid to the Executive on each anniversary of this Agreement a bonus of not less than 50% of Base Salary based on the attainment of the Companies' budgeted (as mutually approved by the Executive and the Boards) results for such period and such other goals, if any, as may be mutually agreeable to the Executive and the Boards; provided, however, that if the Companies have a positive net earnings before taxes and extraordinary and other nonrecurring items ("Net Earnings") in any fiscal year and such Net Earnings are at least equal to the Companies' budgeted (as mutually approved by the Executive and the Boards) Net Earnings for such period, the Executive shall, in lieu of the bonus otherwise payable under the preceding provisions of this Section 3(b), be paid a bonus equal to not less than [2%][__ %] of such Net Earnings if such amount would exceed the amount of the bonus otherwise payable under the preceding provisions of this Section 3(b).

To the maximum extent permitted by law, all payments to the Executive hereunder shall be paid in U.S. Dollars. Subject to the immediately preceding sentence, and subject to the approval of the Executive, which shall not be unreasonably withheld, the Companies may allocate between themselves their obligations to make the payments and provide the benefits specified in this Agreement.

Employee Benefits.

e Executive shall be entitled to the following benefits:

Manager's Insurance. The Companies will pay to an insurance company of the Executive's choice, as premiums for manager's insurance for the Executive, an amount equal to 13.33% of each monthly payment of the Base Salary together with 2.5% of the Base Salary for disability, and will deduct from each monthly payment of the Base Salary and pay to such insurance company an amount equal to 5% of each monthly payment of the Base Salary, which shall constitute the Executive's contribution to such

premiums. Upon the termination of the Executive's employment with the Companies for whatever reason, including without limitation termination for Cause or the resignation by the Executive, the right to receive the manager's insurance benefits shall be automatically assigned to the Executive.

- (b) Education Fund (Keren Hishtalmut). The Companies will contribute to an education fund of the Executive's choice an amount equal to 7.5% of each monthly payment of the Base Salary, and will deduct from each monthly payment of the Base Salary and contribute to such education fund an additional amount equal to 2.5% of each such monthly payment of the Base Salary. Upon the termination of the Executive's employment with the Companies for whatever reason, including without limitation termination for Cause or the resignation by the Executive, the right to receive any amounts in such fund shall be automatically assigned to the Executive.
- (c) Vacation. The Executive shall be entitled to an annual vacation at full pay equal to the number of work days specified in the table below opposite the period for which the Executive has been employed by EFC or any of its subsidiaries, or by Luz Industries Limited or any of its subsidiaries or by Advanced Materials Technology, Inc. or any of its subsidiaries:

<u>Period of Employment</u>	<u>Days of Vacation</u>
Less than three complete years	15
Three complete years or more, but less than six complete years	19
Six complete years or more, but less than eight complete years	21
Nine complete years or more	24

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

- (d) Sick Leave. The Executive shall be entitled to fully paid sick leave pursuant to the Sick Pay Law - 1976; provided, however, that the Executive shall not be entitled to sick leave payment to the extent he is already covered by manager's insurance (except that the Companies shall reimburse the Executive for the Executive's prorated costs of obtaining and maintaining such insurance pursuant to which such coverage was obtained). Sick leave may be accumulated and may, at the Executive's option, be converted into cash payments in an amount equal to the proportionate part of the Base Salary for such days. Payments to which the Executive is entitled pursuant to this Section 4(d) shall be made promptly after the Executive's request therefor.
- (e) Automobile. The Companies shall make an automobile available to the Executive during the term of this Agreement. Such automobile shall be of a type that is generally recognized as a "high quality" automobile in Israel and shall be subject to the approval of the Executive, which shall not be unreasonably withheld. The Executive shall be entitled to use the automobile for his personal and business needs, so long as he does

not allow anyone who would not be covered by the Companies' insurance to drive it. The Companies shall pay all expenses of maintaining and operating the automobile. All expense reimbursements made under this Section shall be tax-effected such that the amount of reimbursement received by the Executive net of any taxes and withholdings (including such amounts in respect of payments pursuant to this sentence) equals the expense incurred.

- (f) Recuperation Payments (D'mai Havra-ah). The Executive shall be entitled to Recuperation Payments in accordance with the Companies' policies for all of its management employees, but no less than required by law.
- (g) Benefit Plans. The Executive shall be entitled to participate in all incentive, bonus, benefit or other similar plans offered by either of the Companies, including without limitation EFC's 1993 Stock Option and Restricted Stock Purchase Plan, in accordance with the terms thereof and as determined by the Boards from time to time.
- (h) Non-Renewal Payments and Benefits. At the conclusion of the Initial Term (or Additional Term, if this Agreement shall be extended beyond the Initial Term), regardless of whether the Executive or the Companies shall have given the notice referred to in Section 1 hereof, the Executive shall receive payments equal to the amounts set forth in Sections 7(b)(i) and (ii) of this Agreement and shall be entitled to the benefits specified in Section 7(b)(iii) of this Agreement.

5. Expenses.

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

6. Termination.

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

- (a) Death. This Agreement shall terminate upon the death of the Executive.
- (b) Disability. The Companies may terminate the Executive's employment after having established the Executive's Disability. For purposes of this Agreement, "Disability" means a physical or mental infirmity which impairs the Executive's ability to substantially perform his duties under this Agreement which continues for a period of at least one hundred and eighty (180) consecutive days.
- (c) Cause. The Companies may terminate the Executive's employment for Cause. For purposes of this Agreement, termination for "Cause" shall mean and include:
 - (i) conviction for fraud, crimes of moral turpitude or other conduct which reflects on the

Companies in a material and adverse manner (it being understood that violations of currency and similar laws will not constitute "Cause" hereunder); (ii) a willful failure to carry out a material directive of either of the Boards, provided that such directive concerned matters within the scope of the Executive's duties, was in conformity with Sections 2(a) and 2(b) hereof and was capable of being reasonably and lawfully performed; (iii) embezzlement of funds of the Companies; and (iv) gross negligence or willful misconduct that is materially harmful to either of the Companies; provided, however, that the Companies may not terminate the Executive for Cause unless they have given the Executive (i) written notice of the basis for the proposed termination given not more than thirty (30) days after the Companies have obtained knowledge of such basis ("Companies' Notice of Termination") and (ii) a period of at least thirty (30) days after the Executive's receipt of such notice in which to cure such basis.

(d) Good Reason. The Executive may terminate his employment under this Agreement for Good Reason. For purposes of this Agreement, "Good Reason" shall mean the occurrence of any of the events or conditions described in subsections (i) through (viii) hereof:

- (i) a change in the Executive's status, title, position or responsibilities which, in the Executive's reasonable judgment, represents a reduction or demotion in the Executive's status, title, position or responsibilities as in effect immediately prior thereto;
- (ii) a reduction in the Executive's Base Salary or a failure by the Companies to increase the Executive's Base Salary within any twelve (12) month period by the average percentage increase during such period of the greater of (a) the base salaries of other senior executive employees or (b) the annual average increase in the salaries of all of the employees of the Companies;
- (iii) the failure by the Companies to continue in effect any material compensation or benefit plan in which the Executive is participating;
- (iv) the insolvency or the filing (by any party, including the Companies) of a petition for the winding-up of either of the Companies;
- (v) any material breach by the Companies of any provision of this Agreement;
- (vi) any purported termination of the Executive's employment for Cause by the Companies which does not comply with the terms of Section 6(c) of this Agreement;
- (vii) any movement of either Company's principal executive offices from the Jerusalem/Tel Aviv area of Israel; and
- (viii) any movement of the location where the Executive is generally to render his services to the Companies hereunder from the Jerusalem/Tel Aviv area of Israel;

provided, however, that the Executive may not terminate his employment under this Agreement for Good Reason unless he has given the Companies (i) written notice of the basis for the proposed termination given not more than thirty (30) days after the Executive has obtained knowledge of such basis ("Executive's Notice of Termination")

and (ii) a period of at least thirty (30) days after the Companies' receipt of such notice in which to cure such basis.

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

- (i) the acquisition (other than from EFC in any public offering or private placement of equity securities) by any person or entity of beneficial ownership of twenty (20%) or more of the combined voting power of EFC's then outstanding voting securities; or
- (ii) individuals who, as of October 1, 1993, were members of the Board of EFC (the "Original EFC Board"), together with individuals approved by a vote of at least two-thirds (2/3) of the individuals who were members of the Original EFC Board and are then still members of the Board of EFC, cease for any reason to constitute at least two-thirds (2/3) of the Board of EFC; or
- (iii) approval by the shareholders of either of the Companies of a complete winding-up of such Company or an agreement for the sale or other disposition of all or substantially all of the assets of either of the Companies; or
- (iv) the transfer of any share of any capital stock of EFL to a person or entity other than EFC.

The Executive shall give to the Companies an Executive's Notice of Termination if the Executive desires to terminate his employment because there has been a change in control, such notice to specify the date of such termination which shall be not less than thirty (30) days after such notice is received by the Companies. Any such notice, to be effective with respect to any Change in Control, must be sent no later than twelve (12) months after such Change in Control.

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

- (i) if the Executive's employment is terminated by the Companies for Cause or due to Disability, the date specified in the Companies' Notice of Termination shall be at least thirty (30) days from the date the Notice of Termination is given to the Executive, provided that in the case of Disability the Executive shall not have returned to the full-time performance of his duties during such period of at least thirty (30) days; and
- (ii) if the Executive's employment is terminated for Good Reason, or because there has been a Change in Control, the Termination Date specified in the Executive's Notice of Termination shall not be more than sixty (60) days from the date the Notice of Termination is given to the Companies.

7. Compensation Upon Termination.

Upon termination of the Executive's employment hereunder, other than because of the expiration of the term of such employment pursuant to Section 1 hereof (in which event the Executive shall receive the amounts and benefits specified in Section 4(h) hereof), the Executive shall be entitled to the following benefits:

- (a) If the Executive's employment is terminated by the Companies for Cause or Disability or by the Executive (other than for Good Reason and other than because there has been a Change in Control), or the Executive's death, the Companies shall pay the Executive all amounts of Base Salary earned or accrued hereunder through the Termination Date but not paid as of the Termination Date (collectively, "Accrued Compensation"); provided, however, that unless the Executive's employment is terminated by the Companies for Cause, the Executive shall also be entitled to payment of a pro rata (based on number of days elapsed since the immediately preceding anniversary of this Agreement) portion of the bonus due pursuant to Section 3(b) hereof for the period ending with the anniversary of this Agreement immediately following such termination and provided, further, that if the Executive's employment is terminated by the Companies for Disability or the Executive's death and the Termination Date is on or after the third anniversary of the date of this Agreement, then the Executive shall be entitled to the benefits specified in clauses (i), (ii), (iii) and (iv) of Section 7(b) hereof, (with the benefits specified in said clause (iii), in the case of the Executive's death, to be for the benefit of persons who were dependents or beneficiaries of the Executive as of such Termination Date).
- (b) If the Executive's employment by the Companies shall be terminated (1) by the Companies other than for Cause or (subject to the second proviso to Section 7(a) hereof) Death or Disability, (2) by the Executive for Good Reason, or (3) by the Executive because there has been a Change in Control, then the Executive shall be entitled to the benefits provided below:
 - (i) the Companies shall pay the Executive all Accrued Compensation and the entire bonus due pursuant to Section 3(b) hereof for the period ending with the anniversary of this Agreement immediately following such termination;
 - (ii) the Companies shall pay the Executive as severance pay (in addition to any amounts payable as severance under law) and in lieu of any further salary for periods subsequent to the Termination Date, in a single payment an amount in cash equal to thirty six (36) times the Executive's Base Salary at the highest rate in effect at any time within the ninety (90) day period ending on the date the Notice of Termination is given (or if the Executive's employment is terminated after a Change in Control, the Executive's Base Salary immediately prior to such Change in Control, if greater);
 - (iii) for a number of months equal to the lesser of (A) thirty six (36) or (B) the number of months remaining until the Executive's 65th birthday, the Companies shall at their expense continue on behalf of the Executive and his dependents and beneficiaries all of the benefits, including without limitation manager's insurance, life insurance, disability, medical, dental and hospitalization benefits and use of an automobile, which were being provided to the Executive at the time Notice of Termination is given (or, if the Executive terminates his employment for Good Reason or because a Change in Control has occurred, the benefits provided to

the Executive at the time immediately preceding when such Good Reason arose or such Change in Control occurred, if greater, or if such benefits are being provided after the Executive's death, the date of his death), provided that the Companies' obligation hereunder with respect to the foregoing benefits shall be limited to the extent that the Executive obtains any such benefits pursuant to a subsequent employer's benefit plans; and

- (iv) all restrictions on any outstanding awards (including restricted share option awards) granted to the Executive shall lapse and such awards shall immediately become fully (100%) vested, and all share options granted to the Executive shall become fully (100%) vested and shall become immediately exercisable.

8. Confidentiality; Proprietary Rights; Competitive Activity.

- (a) Confidentiality. Executive recognizes and acknowledges that the technology, developments, designs, inventions, improvements, data, methods, trade secrets and works of authorship which the Companies own, plan or develop, including without limitation the specifications, documentation and other information relating to the Companies' zinc-air battery systems, and businesses and equipment related thereto (in each case whether for their own use or for use by their clients) are confidential and are the property of the Companies. Executive also recognizes that the Companies' technology, customer lists, supplier lists, proposals and procedures are confidential and are the property of the Companies. Executive further recognizes and acknowledges that in order to enable the Companies to perform services for their clients, those clients may furnish to the Companies confidential information concerning their business affairs, property, methods of operation or other data. All of these materials and information will be referred to below as "Proprietary Information"; provided, however, that such information shall not include any information known generally to the public (other than as a result of unauthorized disclosure by the Executive).
- (b) Non-Disclosure. Executive agrees that, except as directed by the Companies, and in the ordinary course of the Companies' businesses, Executive will not during Executive's employment with the Companies and thereafter, disclose to any person or entity or use, directly or indirectly for Executive's own benefit or the benefit of others, any Proprietary Information, or permit any person to examine or make copies of any documents which may contain or be derived from Proprietary Information; provided, however, that the Executive's duties under this Section 8(b) shall not extend to (i) any disclosure that may be required by law in connection with any judicial or administrative proceeding or inquiry or (ii) any disclosure which may be reasonably required in connection with any actions or proceedings to enforce the Executive's rights under this Agreement. Executive agrees that the provisions of this paragraph shall survive the termination of this Agreement and Executive's employment by the Companies.
- (c) Competitive Activity. The Executive undertakes not, directly or indirectly (whether as owner, partner, consultant, employee or otherwise) at any time, during and for thirty-six (36) months following termination of his employment with the Companies, to engage in or contribute his knowledge to any work or activity that involves a product, process, service or development which is then directly (in any material manner) competitive with the Companies' zinc-air energy systems and the same as or similar to a product, process, service or development on which the Executive worked or with respect to which the Executive had access to Proprietary Information while with the Companies. Notwithstanding the foregoing, the Executive shall be permitted to engage in the

aforementioned proposed work or activity if the Companies furnishes him with written consent to that effect signed by an authorized officer of each Company.

- (d) No Solicitation. During the period specified in 8(c) hereof, Executive will not solicit or encourage any customer or supplier of either Company or of any group, division or subsidiary of either Company, to terminate its relationship with either Company or any such group, division or subsidiary, and Executive will not, directly or indirectly, recruit or otherwise seek to induce any employee of either Company or any such group, division or subsidiary to terminate his or her employment or violate any agreement with or duty to either Company or any such group, division or subsidiary.
- (e) Equitable Relief. The Executive agrees that violations of the covenants in this Section 8 will cause the Companies irreparable injuries and agrees that the Companies may enforce said covenants by seeking injunctive or other equitable relief (in addition to any other remedies the Companies may have at law for damages or otherwise from a court of competent jurisdiction. In the event such court declares these covenants to be too broad to be specifically enforced, the covenants shall be enforced to the largest extent as may be allowed by such court for the Companies' protection. Executive further agrees that no breach by the Companies of, or other failure by the Companies under this Agreement shall relieve the Executive of any obligations under Sections 8(a) and 8(b) hereof.

9. Successors and Assigns.

- (a) This Agreement shall be binding upon and shall inure to the benefit of each Company, its successors and assigns and the Companies shall require any successor or assign to expressly assume and agree to perform this Agreement in the same manner and to the same extent that the Companies would be required to perform it if no such succession or assignment had taken place. The term the "Companies" as used herein shall include such successors and assigns. The term "successors and assigns" as used herein shall mean a corporation or other entity acquiring all or substantially all the assets and business of either Company (including this Agreement) whether by operations of law or otherwise.
- (b) Subject to Section 16 hereof, neither this Agreement nor any right or interest hereunder shall be assignable or transferable by the Executive, his beneficiaries or legal representatives, except by will or by the laws of descent and distribution. This Agreement shall inure to the benefit of and be enforceable by the Executive's legal personal representative.

10. Notice.

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

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

The Companies:

The Executive:

11. Miscellaneous.

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

12. Governing Law.

This Agreement shall be governed by and construed and enforced in accordance with the laws of Israel without application of any conflicts of laws principles which would cause the application of the domestic substantive laws of any other jurisdiction.

13. Severability.

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

14. Entire Agreement.

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

15. Joint and Several Obligations.

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

16. Registration Rights.

- (a) If EFC at any time proposes to register any of its securities under the Securities Act of 1933, as from time to time in effect (together with the rules and regulations thereunder, all as from time to time in effect, the "Securities Act"), for its own account or for the account of any holder of its securities, on a form which would permit registration of Common Stock of EFC at the time held or obtainable upon the exercise of options, warrants or rights, or the conversion of convertible securities, at the time held by the Executive ("Registrable Securities"), for sale to the public under the Securities Act, EFC will each such time give notice to the Executive of its intention to do so. Such notice

shall describe such securities and specify the form, manner and other relevant aspects of such proposed registration. The Executive may, by written response delivered to EFC within 15 days after the giving of any such notice, request that all or a specified part of the Registrable Securities be included in such registration. EFC will thereupon use its best efforts as part of its filing of such form to effect the registration under the Securities Act of all Registrable Securities which EFC has been so requested to register by the Executive, to the extent required to permit the disposition (in accordance with the intended methods thereof as aforesaid) of the Registrable Securities to be so registered.

- (b) The Executive may, by notice to EFC specifying the intended method or methods of disposition, given at any time and from time to time after EFC has registered any shares of its Common Stock under the Securities Act, request that EFC effect the registration under the Securities Act of all or a specified part of the Registrable Securities; provided, however, that EFC shall not be required to effect a registration pursuant to this Section 16(b) unless such registration may be effected on a Form S-3 (or any successor or similar Form); and provided, further, that each registration pursuant to this Section 16(b) shall cover a number of Registrable Shares equal to not less than 2% of the aggregate number of shares of EFC Common Stock then outstanding. EFC will then use its best efforts to effect the registration as promptly as practicable under the Securities Act of the Registrable Securities which EFC has been requested to register by the Executive pursuant to the Section 16(b).
- (c) EFC shall not be obligated to effect any registration of Registrable Securities under Section 16(a) hereof incidental to the registration of any of its securities in connection with mergers, acquisitions, exchange offers, dividend reinvestment plans or stock option or other employee benefit plans.
- (d) EFC hereby agrees to pay, or cause to be paid, all legal, accounting, printing and other expenses (other than the fees and expenses of the Executive's own counsel and other than underwriting discounts and commissions attributable to the Registrable Securities) in connection with each registration of Registrable Securities pursuant to this Section 16.
- (e) In connection with each registration of Registrable Securities pursuant to this Section 16, EFC and the Executive will enter into such agreements, containing such terms and conditions, as are customary in connection with public offerings, such agreements to contain, without limitation, customary indemnification provisions, representations and warranties and opinions and other documents to be delivered in connection therewith, and to be, if requested, with underwriters.
- (f) The provisions of this Section 16 shall be subject to any agreement entered into by EFC, in good faith, with any underwriter of EFC's securities or any person or entity providing financing to EFC, in each case containing reasonable limitations on the Executive's rights and EFC's obligations hereunder.
- (g) The provisions of this Section 16 shall survive the termination of the other provisions of this Agreement. The rights of the Executive under this Section 16 are assignable, in whole or in part, by the Executive to any person or other entity acquiring securities of EFC from the Executive.

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

ELECTRIC FUEL CORPORATION

By: _____
Its: _____

ELECTRIC FUEL LIMITED

By: _____
Its: _____

Executive

Schedule to Form of Management Employment Agreement

The form of Management Employment Agreement is used for three of the Company's Executive Officers:

Officers

Base Salary

Robert S. Ehrlich

\$10,000 per month

Yehuda Harats

\$10,000 per month

Menachem Korall

\$7,500 per month

ENGLISH TRANSLATION OF SUMMARY OF TERMS OF THE
GENERAL EMPLOYMENT AGREEMENTS
USED BY THE COMPANY

A. Temporary Employment Contract.

1. Salary is to be paid by the hour.
2. Social benefits - the minimum required by law.
3. Employment may be cancelled by either party at any time, for any reason.
4. Employee is liable for harm caused to the Company by his gross negligence or intended harm.
5. During his employment and for one year after termination of employment, the employee will keep all matters related to the Company confidential.
6. All intellectual property generated by the employee during his employment is considered to be the Company's property.

B. Standard Employment Contract.

1. Salary is dollar linked (may include provision for overtime).
2. Social benefits (including provision for severance pay) per law.
3. Vacation: 1-3 years, 15 days; 4-6 years, 19 days; 7-8 years, 21 days; 9+ years, 24 days.
4. Sick days - 1.5 days per month.
5. Non-disclosure for term of employment plus five years.
6. Non-competition (direct or indirect) during term of employment and for two years after termination of employment.
7. Publishing technical papers requires Company approval.
8. Intellectual property is Company property.
9. Employee is liable for harm caused to the Company by his gross negligence or intended harm.
10. Employee must give notice and receive notice from the Company 14 days prior to termination of employment (seven days during first six months of employment). There is no notice if gross negligence or a serious violation of the Agreement is made.

Translation From the Original Hebrew

**MINISTRY OF INDUSTRY AND TRADE
INVESTMENT CENTER**

Jerusalem
September 6, 1992
No. 91-0659-0-16212
Entity No: 511532673

Luz Electric Fuel Israel Ltd.
c/o Halevy Dwek & Co.
54 Haneveim Street
Jerusalem

Dear Sirs:

Letter of Approval of Program in the Grant Track

1. The Administration of the Investment Center discussed your application dated July 18, 1991, to approve an investment plan in accordance with the Law for the Encouragement of Capital Investment, 1959 (hereinafter the "Law") for the establishment of a plant in Jerusalem.

The subject of the requested program: manufacture of batteries for electric vehicles.

Extent of investment in the requested program: NIS 1,192.800 (\$497.000).

2. The Administration decided (Decision Number 1075(b)(8), dated May 17, 1992) to approve the investment plan in fixed property in accordance with the Law in the amount of NIS 1,192.800 (\$497.000) only, for establishing a plant for the manufacture of batteries for electric vehicles in Jerusalem, subject to the provisions of this approval letter and the Supplement attached hereto which constitutes an integral part hereof.
3. In accordance with the decision of the Ministerial Committee for Economic Matters CL/66B, dated April 3, 1985 the budget items of the approved plan will be linked as follows:

Investment in structures - to the Construction Price Index (basic index: index of December 1991 of 4883.2 points).

Investment in local equipment and local costs - to the Consumer Price Index (basic index - index of December 1991 of 369.3775 points).

Investment in imported equipment - to the exchange rate of the U.S. Dollar
(basic rate: NIS 2.4 = \$1).

Linkage will not apply to investments that were made between the date of the submission of the application for approval of the plan and the basic index dates stated above.

4. Fulfillment of the following conditions and of the provisions of the Law constitute necessary pre-conditions to the receipt of the benefits conferred by this letter of approval: at least 30% of the investments in fixed property will be financed by paid-in (ordinary) share capital, such that the issuance and payment for the capital will be made in parallel with the ongoing implementation of the investments in the context of the approved plan.
5. Investments in foreign currency of foreign residents in the share capital will be considered approved investments as that term is used in the Law.
6. Implementation of the investment in accordance with the approved plan will entitle you to a investment grant in the amount of 15% and a capital grant in the amount of 5% of the investments.

Receipt of the grant is conditioned on fulfillment of the conditions of the approval and will be subject to the provisions of the Law and to the grant payment practice of the Investment Center.

7. The date of implementing the approved plan will be until September 6, 1993. If by that date it shall be demonstrated to the Investment Center that, with respect to the budget lines dealing with the development of land, buildings and equipment, at least 20% of the extent of the investment program in real terms has been implemented, the date for the implementation [of the entire program] will be extended through September 6, 1994.

This letter does not constitute a recommendation or an approval for the receipt of loans or benefits from any other governmental source, nor is it a condition to the receipt of any such loans or benefits.

Attached hereto is the Supplement to this letter and details of the approved program which constitute a integral parts of this letter of approval.

Sincerely,

/ S /

Moshe Teri

Director of the Investment Center

T1/BPL/Trans/kg

Translation From the Original Hebrew

**MINISTRY OF INDUSTRY AND TRADE
INVESTMENT CENTER**

Jerusalem
December 6, 1992
No. 91-0659-0-16212
Entity No. 511532673

Luz Electric Fuel Israel Ltd.
c/o Halevy Dwek & Co.
54 Hancveim Street
Jerusalem

Dear Sirs:

Letter of Approval for Hi-Technology Plant
Supplement No.1 to Letter of Approval dated September 6, 1992

1. In accordance with the recommendation of the Office of the Chief Scientist of the Ministry of Industry and Trade on the authority granted him in his capacity as stated in Section 2(d) of the Jerusalem Development Authority (Hi-Technology Plants) Regulations, 1990, and subject to the Jerusalem Development Authority Law, 1988, I hereby modify that stated in our Approval dated September 6, 1992, and confirm that your plant which will be established in Jerusalem will have the status of Development Zone A.
2. Accordingly, the implementation of the investment in accordance with the approved plan will entitle you to an investment grant in the amount of 30% and a capital grant in the amount of 8% of your investment.

The remaining details of the approval and its Supplement remain in full force.

Sincerely,

/ S /
Etty Azriel
Supervisor of the Program Inspection Branch

T1/BPL/Trans1/kg

[Translation from
Hebrew Original]

STATE OF ISRAEL
Office of Industry and Commerce
Administrator of Research and Industrial Development
Office of Chief Scientist

Jerusalem
January 27, 1994
Our Ref: 108

Electric Fuel Ltd.
Kiryat Mada 5
P.O.B. 23073
Jerusalem 91230

Re: Transfer of Manufacturing Rights Abroad

Dear Sirs:

Pursuant to Section 17(d) and Section 50 of the Law for the Encouragement of Industrial Research and Development, 1984, the Chief Scientist presented the agreement between the Dutch company and the Italians in addition to:

1. Opinion of the law offices of Yigal Arnon & Co. confirming that the above-referenced agreement does not relate to the transfer of know-how abroad.
2. Clarification letter from the Italian company that it is acceptable to it that 35% of the aggregate production will be done in Israel by EFL.

Resolved:

1. To approve the agreement dated May 20, 1993, provided that the production performed in Israel will not be less than 35% of the aggregate production in the context of this agreement.
2. To approve the securities offering in the U.S. in the amount of up to 25% of the shares of the U.S. parent company.

Due to lack of time the issue of royalties was not discussed and will be postponed to a later meeting.

Sincerely,

/s/

Lydia Laznes
Head of Budget and Payments



Translation from Hebrew

THE STATE OF ISRAEL

Ministry of Industry & Trade
Industrial R&D Administration
Office of Chief Scientist
Jerusalem

January 4, 1995

To: Mr. Yehuda Harats - Managing Director
Electric Fuel Ltd.

Re: Arrangement of the Royalty Issue

Further to the meeting held in the Chief Scientist's office, between representatives of the Company and representatives of the Office of the Chief Scientist ("OCS"), and in light of the Company's willingness to respond to the OCS's demand for the reimbursement of the grant, you as the Company's Managing Director and I were given the task or reaching a detailed settlement agreement taking into account the amount of grant to be paid, the method of payment, a solution for the future, and the postponement of the payment of royalties with regard to new programs.

The following are the main points of the agreements we reached:

Amount to be Paid

The assignment of files to [specific] projects is not unequivocal - according to OCS's policies, the Company has five files assigned to one project for which the Company received \$2,304,741. Included in this project are two files belonging to the (now defunct) Luz company, and the Company has assumed the duties and rights [of those files] (pursuant to a decision of the Research Committee). It should be noted that this assignment is based upon technology and includes two products: batteries for power stations and batteries for vehicles.

Since the Company has transferred the production rights only for vehicle batteries, the Company requests to distinguish between the products and to split the two Luz files to the different products. According to the professional examiner, in the event of a compromise, half of each Luz file should be assigned to the vehicle batteries, and therefore the amount of the grant is \$1,712,279. The separation of files according to actual expenses results in an obligation of the Company to repay \$1,514,668.

According to the Company, the Luz files, particularly the first one, did not contribute to the technology now being used for vehicle batteries, but as a compromise, the Company is willing to include the actual expenses in regard to vehicle batteries from the second file, and based on this approach the amount to be repaid is \$1,241,568.

It was agreed to combine the examiner's approach and the Company's approach, and therefore only Luz's second file shall be considered as half, and therefore the amount of the grant to be repaid is \$1,322,818.

File No.	Developing Company	Amount of grant	The Principal Approach(!)	The Examiner's Approach(*)	The Company's Approach	Agreed
12117	Luz	778,992	273,100	389,461	0	0
12967	Luz	406,071	121,900	203,035	121,900	203,071
13681	Electric Fuel	147,114	147,114	147,114	147,114	147,114
14172	Electric Fuel	537,330	537,330	537,330	537,330	537,330
15576	Electric Fuel	435,303	435,303	435,303	435,303	435,303
Total		2,304,740	1,514,747	1,712,243	1,241,677	1,322,818

(!) The Principal Approach means the division of the Luz files according to actual expenses.

(*) The Professional Examiner's Approach means the arbitrary division of Luz files by 50%.

Allocation to Projects

In general, the Company agrees that as of today all of the Company's files (including the Luz files mentioned above) constitute one Project. For technical reasons, the Company's files will be divided into three Projects (however, the connection in principle of mutual obligation will be retained) as follows:

Luz files - the files belonging to Luz (less the half file being transferred to the vehicle batteries as part of this agreement).

The Italian files - the R&D files where the grant is returned due to the transfer of rights to the Italians.

New files - new files for which the Company shall receive grants for the period commencing January 1, 1994.

Solution for the Future

When the agreement becomes effective, the OCS and the Company shall regard the financial issue alone as zeroed out - as if the Company did not invest in R&D and the OCS did not invest in R&D (apart from the obligation for the Luz files).

According to the Company's representation, the sole agreement at this point regarding the transfer of manufacturing rights abroad is the Italian agreement. All new agreements will be brought for prior approval to the Research Committee (before being signed).

Luz Files - In general (after the period of the payment arrangement) shall be returned according to regular royalty rates and the grant ceiling for them shall be 100%, except for the following cases:

- In the event that manufacturing rights regarding vehicles are transferred abroad (in addition to the Italians), the Company shall pay out of revenues received for the

transfer of rights (during the period of the payment arrangement as well) royalties according to the regular royalty rate with a grant ceiling of 100%.

In the event that manufacturing rights regarding power stations are transferred abroad, the Company shall pay royalties at an increased rate to be determined by the Research Committee at such time.

Italian Files - the entire grant is returned under this Agreement.

Revenues from the Italians (for which there is no [corresponding] expense) received after the period of the payment arrangement shall be subject to royalties up to the amount of the grants in the new files (100% of the amount grant) according to the new royalty rate (see definition below).

Other revenues received from the Italians after the period of the payment arrangement shall be subject to royalties up to the amount of the grants in the Luz files and in the new files at regular royalty rates (for these purposes, grant ceiling in the Luz files shall be as stated above - 100% of the grant).

New Files - shall be repaid according to the regular royalty rate and a grant ceiling of 100%. In the event that manufacturing rights are transferred abroad (in addition to the Italians), the royalty rate on revenues received for the transfer of manufacturing rights shall be calculated by the ratio between the amount of the grant divided by the total amount of the Company's investment in R&D, and the grant ceiling shall be increased as is customary in the transfer of manufacturing rights (hereinafter "new royalty rate"). For this calculation, the agreement with the Italians will not be taken into account and the amounts of investment (the Company's and the OCS's) shall also not be taken into account until 1994 in the calculation of rates and the grant ceiling.

Payment Arrangement

It has been agreed that the Company shall repay the entire grant in three installments within two years, as follows:

By 31.12.94 - 30% of the amount of the debt;

By 31.12.95 - 30% of the amount of the debt;

By 31.12.96 - 40% of the amount of the debt.

The debts are linked to the consumer price index and bear an annual interest of 4%.

The Company shall have the alternative option to pay the grant in full by the end of 1995, linked to the index without interest, in accordance with the following:

By 31.12.94 - 30% of the amount of the debt

By 31.12.95 - 70% of the amount of the debt.

Upon the completion of the payment arrangement, the Company will not have any additional financial obligations arising from the Italian files or the Luz files except for

the obligations set forth above. For the avoidance of doubt, the Company is obligated to continue to comply with all of the requirements of the R&D law and regulations.

Grace

Aside from the payment arrangement, the Company is obligated to pay royalties as mentioned above. These royalties shall be paid for sales starting from the second half of 1996.

Sincerely,

Moshe Berdugo
Manager of Tmura Fund

EX-10.3 5 v039231_10-3.htm

PROMISSORY NOTE

December 3, 1999

FOR VALUE RECEIVED, the undersigned ("Maker") hereby promises to pay to the order of Electric Fuel Corporation, a Delaware corporation ("EFC"), on the earlier of (a) ten years from the date of this note or (b) the date of termination of the Maker's employment with EFC, the principal sum of One Hundred Sixty-Seven Thousand Nine Hundred Seventy-Five dollars (U.S. \$167,975), together with simple interest from the date hereof on the principal amount at a per annum rate equal to 2%. Simple interest on this note will be calculated and charged, in advance, based on a term of ten years, and will be due and payable in proportional payments when principal is paid. This note may be prepaid in whole or in part at any time, without premium, penalty or prior notice.

This note is secured by a pledge to EFC of the 125,000 shares of EFC's common stock, par value\$.01 per share (the "Common Stock"), acquired with this note (the "Pledged Shares"). The recourse under this note shall only be to the Pledged Shares.

To perfect EFC's security interest in the Pledged Shares, the Maker shall deliver to EFC the stock certificate or certificates representing the Pledged Shares, together with stock powers duly endorsed in blank. EFC shall release its security interest in the Pledged Shares in proportion to payment of principal and interest owed hereunder.

This note shall be governed by and construed in accordance with the laws (other than the conflict of law rules) of the State of New York.

IN WITNESS WHEREOF, I have hereunto set my hand as of this 3rd day of December, 1999.

Robert S. Ehrlich

EX-10.4 6 v039231_10-4.htm

PROMISSORY NOTE

February 9, 2000

FOR VALUE RECEIVED, the undersigned ("Maker") hereby promises to pay to the order of Electric Fuel Corporation, a Delaware corporation ("EFC"), twenty-five years from the date of this note, the principal sum of Three Hundred Twenty-Nine Thousand One Hundred Twenty-Three dollars (U.S. \$329,163), together with simple interest from the date hereof on the principal amount at a per annum rate equal to 1% over the then-current federal funds rate announced from time to time by the *Wall Street Journal*. The Maker will accumulate such interest until the principal has been paid in full. All accrued but unpaid interest shall be due and payable at the stated or accelerated maturity hereof. This note may be prepaid in whole or in part at any time, without premium, penalty or prior notice.

In order to secure the prompt payment of the principal of, interest on, and all other amounts in respect of this Note as the same shall become due and payable, the Maker hereby pledges to EFC, and grants EFC a security interest in, the 131,665 shares (the "Pledged Shares") of EFC's Common Stock, \$.01 par value, acquired with this note. The recourse under this note shall only be to the Pledged Shares.

To perfect EFC's security interest in the Pledged Shares, the Maker shall deliver to EFC the stock certificate or certificates representing the Pledged Shares, together with stock powers duly endorsed in blank. EFC shall release its security interest in the Pledged Shares in proportion to payment of principal and interest owed hereunder.

This note shall be governed by and construed in accordance with the laws (other than the conflict of law rules) of the State of New York.

IN WITNESS WHEREOF, I have hereunto set my hand as of this 9th day of February, 2000.

Robert S. Ehrlich

EX-10.5 7 v039231_10-5.htm

PROMISSORY NOTE

\$36,500.00
July 1, 2002

New York, New York

FOR VALUE RECEIVED, Robert S. Ehrlich (“Maker”) hereby promises to pay to the order of Electric Fuel Corporation (“EFC”), at 632 Broadway, New York, New York, or at such other place as may be designated in writing by EFC or any subsequent holder of this Note (“Holder”), the principal sum of Thirty-Six Thousand Five Hundred Dollars (\$36,500.00), on July 1, 2012, together with simple interest from the date hereof on the principal amount from time to time unpaid at a per annum rate equal to the lesser of (i) 5.75%, and (ii) 1% over the then-current Federal Fund Rate, until the principal sum is paid in full. Interest will accrue on the loan until maturity.

All payments hereunder shall be made in United States Dollars only. Maker may prepay this Note at any time and from time to time without premium or penalty.

Maker will bear no personal liability on the principal and accrued interest of this Note.

In the event that the Maker files or has filed against the Maker any petition under any bankruptcy or insolvency law or for the appointment of a receiver or makes a general assignment for the benefit of creditors, then the entire unpaid principal of this note, together with accrued interest thereon, shall automatically become immediately due and payable. No failure by the holder to take action with respect to any default hereunder shall affect its subsequent rights to take action with respect to the same or any other default. In the event of default the Maker agrees to pay all reasonable costs of collection, including reasonable attorneys’ fees, to the extent allowed by law.

This Note shall be secured by a pledge to EFC of 50,000 shares (the “Pledged Shares”) of EFC’s common stock, \$0.01 par value, acquired with this note.

The recourse under this note shall only be to the Pledged Shares. EFC shall have all rights of a secured party under the Uniform Commercial Code as in effect in the State of New York, including without limitation all remedies available thereunder to a secured party in the event of a default in the performance of the obligation secured, with respect to the Pledged Shares, and Maker will take all actions reasonably requested by EFC to perfect such security interest, including without limitation delivering to EFC the stock certificate or certificates representing the Pledged Shares, together with stock powers duly endorsed in blank. EFC shall release its security interest in the Pledged Shares when all principal and interest owed hereunder have been paid in full. Notwithstanding the foregoing, EFC shall sell Pledged Shares per Maker’s instructions from time to time, provided that with respect to any and each such sale EFC may withhold from the proceeds of such sale that percentage of the original principal and accrued but unpaid interest under this Note as the Pledged Shares sold shall bear to the original 50,000 Pledged Shares (so that if, for example, Maker instructs EFC to sell 14,000 Pledged Shares, EFC shall be entitled to withhold from the proceeds of such sale 28% of the original principal amount and accrued but unpaid interest under this Note).

The Maker hereby waives presentment, demand, notice of nonpayment, protest and all other demands, notices and defenses (other than payment) in connection with the delivery, acceptance, performance and enforcement of this note.

This Note shall be deemed to have been made under and shall in all respects be governed by the internal laws of the State of New York without reference to conflicts of laws. Maker consents to the exclusive jurisdiction of the courts in New York, New York with respect to any and all suits brought in connection with this Agreement, and waives any right to object to the personal or subject matter jurisdiction of such court and waives any right to move dismissal based on grounds of *forum non conveniens*.

IN WITNESS WHEREOF, the undersigned has duly executed and delivered this Note as of the 1st day of July, 2002.

Robert S. Ehrlich

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 <TYPE>EX-4.2
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Exhibit 4.2

FORM OF
 COMMON STOCK PURCHASE WARRANT
 ELECTRIC FUEL CORPORATION

Expires May 8, 2006

No.: W-_____ Number of Shares:_____

Date of Issuance: May 8, 2001

1. Issuance. In consideration of good and valuable consideration, the

receipt of which is hereby acknowledged by Electric Fuel Corporation, a Delaware corporation (the "Company"), _____, or registered assigns (the "Holder") is hereby granted the right to purchase at any time and from time to time after November 8, 2001 to and until 5:00 p.m., New York time, on May 8, 2006 (the "Expiration Date"), _____ (_____) fully paid and nonassessable shares (the "Warrant Shares") of the Company's Common Stock, par value \$.01 per share (the "Common Stock"), at an exercise price per share equal to \$3.22 (the "Exercise Price"). The Exercise Price and the number of shares for which the Warrant is exercisable shall be subject to adjustment as provided herein. Certain capitalized terms used herein are defined in Section 16 hereof.

2. Exercise of Warrants. Except as provided in Section 4 below, commencing

after November 8, 2001 exercise of the purchase rights represented by this Warrant may be made at any time or times, before the close of business on the Expiration Date, or such earlier date on which this Warrant may terminate as provided in this Warrant, by the surrender of this Warrant, together with a completed exercise agreement in the form attached hereto (the "Exercise Agreement"), to the Company during normal business hours on any business day at the Company's principal executive offices (or such other office or agency of the Company as it may designate by notice to the Holder), and upon payment to the Company in United States dollars in cash, by certified check or cashier's check, or by wire transfer to an account designated by the Company of immediately available funds, in an amount equal to the Exercise Price multiplied by the number of Warrant Shares specified in the Exercise Agreement to be purchased. The Warrant Shares so purchased shall be deemed to be issued to the Holder or such Holder's designee, as the record owner of such shares, as of the close of business on the date on which this Warrant shall have been surrendered, the completed Exercise Agreement shall have been delivered, and payment shall have been made for the Warrant Shares as set forth above or, if such date is not a business date, on the next succeeding business date. The Warrant Shares so purchased, representing the aggregate number of shares specified in the Exercise Agreement, shall be delivered to the Holder within a reasonable time, not exceeding three business days, after this Warrant shall have been so exercised. If the Company's transfer agent is participating in the Depository Trust Company ("DTC") Fast Automated Securities Transfer program, the Company

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will cause its transfer agent to electronically transmit the Warrant Shares so purchased to the Holder by crediting the account of the Holder or its nominee with DTC through its Deposit Withdrawal Agent Commission system ("DTC Transfer"). If the aforementioned conditions to a DTC Transfer are not satisfied, the Company will deliver to the Holder physical certificates representing the Warrant Shares so purchased. Further, the Holder may instruct the Company to deliver to the Holder physical certificates representing the Warrant Shares so purchased in lieu of delivering such shares by way of DTC Transfer. Any certificates so delivered shall be in such denominations as may be reasonably requested by the Holder, shall be registered in the name of such Holder or such other name as shall be designated by such Holder, and shall not bear any restrictive legend, unless otherwise required by law. If this Warrant shall have been exercised only in part, then the Company will, at the time of delivery of the certificates for the Warrant Shares purchased, deliver to the Holder a new Warrant representing the number of shares with respect to which this Warrant shall not then have been exercised.

3. Reservation and Registration of Shares. The Company hereby

covenants that at all times during the term of this Warrant there shall be reserved a sufficient number of shares of its Common Stock as shall be required for issuance upon exercise of this Warrant. The Company further covenants to take such actions as the Company shall reasonably determine necessary to continue the registration of the Warrant Shares under the Securities Act of 1933, as amended.

4. No Fractional Shares or Scrip. No fractional shares of Common Stock

are to be issued upon the exercise of this Warrant, but the Company will pay a cash adjustment in respect of any fractional share which would otherwise be issuable in an amount equal to the same fraction of the Market Price of a share of Common Stock on the date of such exercise.

5. Loss, Theft, Destruction or Mutilation of Warrant. Upon receipt by

the Company of evidence satisfactory to it of the loss, theft, destruction or mutilation of this Warrant, and (in the case of loss, theft or destruction) receipt of reasonably satisfactory indemnification, and (in the case of mutilation) upon surrender and cancellation of this Warrant, the Company will execute and deliver a new Warrant of like tenor and date and any such lost, stolen, destroyed or mutilated Warrant shall thereupon become void.

6. Rights of the Holder. The Holder shall not, by virtue hereof, be

entitled to any rights of a stockholder in the Company, either at law or equity, and the rights of the Holder are limited to those expressed in this Warrant and are not enforceable against the Company except to the extent set forth herein.

7. Adjustments of Exercise Price and Number of Warrant Shares. The

number and kind of securities purchasable upon the exercise of this Warrant and the Exercise Price shall be subject to adjustment from time to time upon the happening of any of the following.

In case the Company shall (i) declare or pay a dividend in shares of Common Stock or make a distribution in shares of Common Stock to holders of its outstanding Common Stock, (ii) subdivide its outstanding shares of Common Stock, (iii) combine its outstanding shares of Common Stock into a smaller number of shares of Common Stock or (iv) issue any shares of its capital stock in a reclassification of the Common Stock, then the number of Warrant Shares

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purchasable upon exercise of this Warrant immediately prior thereto shall be adjusted so that the Holder shall be entitled to receive the kind and number of Warrant Shares or other securities of the Company which the Holder would have owned or have been entitled to receive had such Warrant been exercised in advance thereof. Upon each such adjustment of the kind and number of Warrant Shares or other securities of the Company which are purchasable hereunder, the Holder shall thereafter be entitled to purchase the number of Warrant Shares or other securities resulting from such adjustment at an Exercise Price per such Warrant Share or other security obtained by multiplying the Exercise Price in effect immediately prior to such adjustment by the number of Warrant Shares purchasable pursuant hereto immediately prior to such adjustment and dividing by the number of Warrant Shares or other securities of the Company resulting from such adjustment.

An adjustment made pursuant to this Section 7 shall become effective immediately after the effective date of such event retroactive to the record date, if any, for such event.

8. Notice of Adjustment. Whenever the number of Warrant Shares or number

or kind of securities or other property purchasable upon the exercise of this Warrant or the Exercise Price is adjusted as herein provided, the Company shall promptly mail by registered or certified mail, return receipt requested, to the Holder notice of such adjustment or adjustments setting forth the number of Warrant Shares (and other securities or property) purchasable upon the exercise of this Warrant and the Exercise Price of such Warrant Shares (and other securities or property) after such adjustment, setting forth a brief statement of the facts requiring such adjustment and setting forth the computation by which such adjustment was made. Such notice, in absence of manifest error, shall be conclusive evidence of the correctness of such adjustment.

9. Warrant Call. Except as provided in this Section 9, commencing on

November 8, 2001, the Company shall have the right, at any time or from time to time, at the Company's option, upon written notice to the Holder (the "Call Notice"), to call this Warrant if the Market Price of the Common Stock is equal to or greater than \$6.44 per share for 20 consecutive Trading Days prior to the date the Company calls the Warrant. To be effective, the Call Notice must be given within ten days after the aforementioned 20 day period. The Company shall specify a "Call Date", the date all rights and privileges granted pursuant to this Warrant shall terminate, in its Call Notice, which shall be no less than 30 business days from the date of receipt by the Holder of the Call Notice. In the event that this Warrant has not been exercised in full by the Holder by 5:00 p.m. New York time on the Call Date, this Warrant shall expire and no rights or privileges shall exist hereunder, and the Company will remit to the Holder \$0.01 per Warrant Share subject to this Warrant as of the Call Date.

10. Notices. Any notice or other communication required or permitted

hereunder shall be given in writing and shall be deemed effectively given (a) upon personal delivery to the person to be notified (b) five days after deposit with a domestic Post Office, by registered mail, postage prepaid and addressed to the person to be notified, (c) upon confirmed transmission by electronic facsimile to the fax number specified for such person, (d) two business days after sent by certified mail (first class, postage prepaid) and addressed to the person to be notified or (e) next day for delivery by guaranteed overnight delivery, which delivery is confirmed. The addresses for such communications shall be with respect to the Holder of this Warrant or of

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Warrant Shares issued pursuant hereto, addressed to such Holder at its last know address or facsimile number appearing on the books of the Company maintained for such purposes, or with respect to the Company, addressed to:

Electric Fuel Corporation
632 Broadway, Suite 301
New York, New York 10012
Facsimile No.: (212) 529-5800
Attn: Yaakov Har-Oz, Vice President
and General Counsel

or to such other address or addresses or facsimile number or numbers as any such party may most recently have designated in writing to the other party hereto by notice given in accordance with this Section.

11. Supplements and Amendments; Whole Agreement. This Warrant may be

amended or supplemented only by an instrument in writing signed by the parties hereto. This Warrant contains the full understanding of the parties hereto with respect to the subject matter hereof and there are no representations, warranties, agreements or understandings other than expressly contained herein and therein.

12. Governing Law. This Warrant shall be deemed to be a contract made

under the laws of the State of New York and for all purposes shall be governed by and construed in accordance with the laws of such State applicable to contracts to be made and performed entirely within such State.

13. Counterparts. This Warrant may be executed in any number of

counterparts and each of such counterparts shall for all purposes be deemed to be an original, and all such counterparts shall together constitute but one and the same instrument.

14. Descriptive Headings. Descriptive headings of the several Sections of

this Warrant are inserted for convenience only and shall not control or affect the meaning or construction of any of the provisions hereof.

15. Severability. If any term, provision, covenant or restriction of this

Warrant is held by a court of competent jurisdiction to be invalid, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions of this Warrant shall remain in full force and effect and shall in no way be affected, impaired or invalidated.

16. Certain Definitions.

(i) "Market Price," as of any date, (i) means the last sale price

for the shares of Common Stock as reported on the Nasdaq National/SmallCap Market by Bloomberg Financial Markets ("Bloomberg") for a Trading Day, or (ii) if the Nasdaq National/SmallCap Market is not the principal trading market for the shares of Common Stock, the reported closing bid price reported by Bloomberg on the principal trading

market for the Common Stock for a Trading Day, or, if there is no bid price, the last sales price reported by Bloomberg for a Trading Day, or

(iii) if the foregoing do not apply, the last sale price of such security in the over-the-counter market on the pink sheets or bulletin board for such security as reported by Bloomberg for any Trading Day, or if no sale price is so reported for such security, the last bid price of such security as reported by Bloomberg for any Trading Day.

(ii) "Trading Day", means any business day on which the principal

United States securities exchange or trading market on which Common Stock is listed or traded and reported by Bloomberg Financial Markets (or a comparable reporting service of national reputation selected by the Company and reasonably acceptable if Bloomberg Financial Markets is not then reporting closing bid prices of such security) is open for trading.

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IN WITNESS WHEREOF, the Company has caused this Warrant to be signed and attested by its duly authorized officers under its corporate seal and is dated the ____ day of May, 2001.

ELECTRIC FUEL CORPORATION

Witness

By: _____
Name:
Title:

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[FORM OF NOTICE OF EXERCISE]

(To be Executed by the Holder in order to Exercise the Warrant)

To: ELECTRIC FUEL CORPORATION
632 Broadway, Suite 301
New York, New York 10012
Facsimile: (212) 529-5800
Attn: Yaakov Har-Oz, Vice President and General Counsel

The undersigned hereby irrevocably exercises the right to purchase _____ shares of the Common Stock of ELECTRIC FUEL CORPORATION, a corporation organized under the laws of the State of Delaware (the "Company"), evidenced by the attached Warrant, and herewith makes payment of the Exercise Price with respect to such shares in full, all in accordance with the conditions and provisions of said Warrant.

The undersigned agrees not to offer, sell, transfer or otherwise dispose of any Common Stock obtained on exercise of the Warrant, except under circumstances that will not result in a violation of the Securities Act of 1933, as amended, or any state securities laws.

The undersigned requests that the Company cause its transfer agent to electronically transmit the Common Stock issuable pursuant to this Exercise Agreement to the account of the undersigned or its nominee (which is _____) with DTC through its Deposit Withdrawal Agent Commission System ("DTC Transfer"), provided that such transfer agent participates in the DTC Fast Automated Securities Transfer program.

In lieu of receiving the shares of Common Stock issuable pursuant to this Exercise Agreement by way of DTC Transfer, the undersigned hereby requests that the Company cause its transfer agent to issue and deliver to the undersigned physical certificates representing such shares of Common Stock.

The undersigned requests that a Warrant representing any unexercised portion hereof be issued, pursuant to the Warrant, in the name of the Holder and delivered to the undersigned at the address set forth below:

Dated: _____

Signature of Holder

Name of Holder (Print)

Address:

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FORM OF ASSIGNMENT

FOR VALUE RECEIVED, the undersigned hereby sells, assigns, and transfers all the rights of the undersigned under the within Warrant, with respect to the number of shares of Common Stock covered thereby set forth hereinbelow, to:

Name of Assignee	Address	No. of Shares
-----	-----	-----

, and hereby irrevocably constitutes and appoints _____ as agent and attorney-in-fact to transfer said Warrant on the books of the within-named corporation, with full power of substitution in the premises.

Dated: _____, ____

In the presence of

Name: _____

Signature: _____
Title of Signing Officer or Agent (if any):

Address: _____

Note: The above signature should correspond exactly with the name on the face of the within Warrant.

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Exhibit 4.1

SECURITIES PURCHASE AGREEMENT

This Securities Purchase Agreement (this "AGREEMENT") is dated as of December 31, 2002, by and among Electric Fuel Corporation, a Delaware corporation (the "COMPANY"), and the purchasers identified on the signature pages hereto (each a "PURCHASER" and collectively the "PURCHASERS").

WHEREAS, subject to the terms and conditions set forth in this Agreement and pursuant to Section 4(2) of the Securities Act (as defined below) and Rule 506 promulgated thereunder, the Company desires to issue and sell to the Purchasers, and the Purchasers, severally and not jointly, desire to purchase from the Company certain securities of the Company, as more fully described in this Agreement.

NOW, THEREFORE, IN CONSIDERATION of the mutual covenants contained in this Agreement, and for other good and valuable consideration the receipt and adequacy of which are hereby acknowledged, the Company and the Purchasers agree as follows:

ARTICLE I. DEFINITIONS

1.1 Definitions. In addition to the terms defined elsewhere in this Agreement, for all purposes of this Agreement, the following terms shall have the meanings indicated in this Section 1.1:

"ACTION" means any action, suit, inquiry, notice of violation, proceeding (including any partial proceeding such as a deposition) or investigation pending or threatened in writing against or affecting the Company, any Subsidiary or any of their respective properties before or by any court, arbitrator, governmental or administrative agency, regulatory authority (federal, state, county, local or foreign), stock market, stock exchange or trading facility.

"AFFILIATE" means any Person that, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with a Person, as such terms are used in and construed under Rule 144.

"BUSINESS DAY" means any day except Saturday, Sunday and any day which shall be a federal legal holiday or a day on which banking institutions in the State of New York are authorized or required by law or other governmental action to close.

"CLOSING" means the closing of the purchase and sale of the Securities pursuant to Section 2.

"CLOSING DATE" means the date of the Closing.

"COMMISSION" means the Securities and Exchange Commission.

"COMMON STOCK" means the common stock of the Company, \$.01 par value per

share, and any securities into which such common stock may hereafter be reclassified.

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"COMMON STOCK EQUIVALENTS" means any securities of the Company or any Subsidiary which entitle the holder thereof to acquire Common Stock at any time, including without limitation, any debt, preferred stock, rights, options, warrants or other instrument that is at any time convertible into or exchangeable for, or otherwise entitles the holder thereof to receive, Common Stock or other securities that entitle the holder to receive, directly or indirectly, Common Stock.

"COMPANY COUNSEL" means Yaakov Har-Oz, Esq.

"DEBENTURES" means \$3,500,000 in the aggregate principal amount of 9% Secured Convertible Debentures due on the thirtieth (30th) month anniversary of the issuance thereof, in the form of Exhibit A hereto.

"EFFECTIVE DATE" means the date that the initial Registration Statement required by the Registration Rights Agreement is first declared effective by the Commission.

"EXCHANGE ACT" means the Securities Exchange Act of 1934, as amended.

"FIRST WARRANTS" means common stock purchase warrants issuable to each Purchaser at the Closing, in the form attached hereto as Exhibit C-1.

"INDEBTEDNESS" shall mean the principal amount of, premium, if any, profit participation, if any, and accrued and unpaid interest on and all other amounts and costs payable in respect of (a) indebtedness for money borrowed from others; (b) indebtedness guaranteed, directly or indirectly, in any manner, or in effect guaranteed, directly or indirectly, in any manner through an agreement, contingent or otherwise, to supply funds to, or in any other manner invest in the debtor, or to purchase indebtedness, or to purchase and pay for property if not delivered or pay for services if not performed, primarily for the purpose of enabling the debtor to make payment of the indebtedness or to assure the owners of the indebtedness against loss; (c) all indebtedness secured by any mortgage, lien, pledge, charge or other encumbrance upon property owned by the Company; (d) all indebtedness of such Person created or arising under any conditional sale, lease (intended primarily as a financing device) or other title retention or security agreement with respect to property acquired by the Company even though the rights and remedies of the seller, lessor or lender under such agreement or lease in the event of a default may be limited to repossession or sale of such property; and (e) renewals, extensions and refundings of any such Indebtedness.

"INTELLECTUAL PROPERTY SECURITY AGREEMENT" means the Intellectual Property Security Agreement, dated as of the date of this Agreement, by and among the Company, the subsidiaries of the Company party thereto, and the holders of the Debentures, pursuant to which the obligations of the Company under the Debentures are secured by the intellectual property of the Company and the subsidiaries party thereto, such agreement in the form of Exhibit D attached hereto.

"INVESTMENT AMOUNT" means, with respect to each Purchaser, the investment amount indicated below such Purchaser's name on the signature page of this Agreement

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"LIEN" means any lien, charge, encumbrance, security interest, right of first refusal or other restrictions of any kind.

"PERSON" means an individual or corporation, partnership, trust, incorporated or unincorporated association, joint venture, limited liability company, joint stock company, government (or an agency or subdivision thereof) or other entity of any kind.

"PROCEEDING" means an action, claim, suit, investigation or proceeding (including, without limitation, an investigation or partial proceeding, such as a deposition), whether commenced or threatened.

"PURCHASER PERCENTAGE" means, with respect to a Purchaser, the percentage equal to the product of (x) a fraction, the numerator of which shall be the Investment Amount paid by such Purchaser on the Closing Date and the denominator of which shall be the aggregate Investment Amount paid by all Purchasers on the Closing Date times (y) 100.

"REGISTRATION STATEMENT" means a registration statement meeting the requirements set forth in the Registration Rights Agreement and covering the resale by the Purchasers of the Underlying Shares and the Warrant Shares.

"REGISTRATION RIGHTS AGREEMENT" means the Registration Rights Agreement, dated as of the date of this Agreement, among the Company and the Purchasers, in the form of Exhibit B hereto.

"RULE 144" means Rule 144 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar rule or regulation hereafter adopted by the Commission having substantially the same effect as such Rule.

"SECOND WARRANTS" means common stock purchase warrants issuable to each Purchaser at the Closing, in the form attached hereto as Exhibit C-2.

"SECURITIES" means the Debentures, the Underlying Shares, the Warrants and the Warrant Shares.

"SECURITIES ACT" means the Securities Act of 1933, as amended.

"SECURITY AGREEMENT" means the Security Agreement, dated as of the date of this Agreement, by and among the Company and the subsidiaries of the Company party thereto and the holders of the Debentures, pursuant to which the obligations of the Company under the Debentures are secured by the assets of the Company and its subsidiaries, such agreement in the form of Exhibit E.

"SUBSIDIARY" means any subsidiary of the Company that is required to be listed in Schedule 3.1(a), provided, that to the extent no subsidiaries are

listed in Schedule 3.1(a), any reference to "Subsidiary" or "Subsidiaries" in the Transaction Documents shall be disregarded.

"THIRD WARRANTS" means common stock purchase warrants issuable to each Purchaser at the Closing, in the form attached hereto as Exhibit C-3.

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"TRADING DAY" means (i) a day on which the Common Stock is traded on a Trading Market, or (ii) if the Common Stock is not listed on a Trading Market, a day on which the Common Stock is traded in the over-the-counter market, as reported by the OTC Bulletin Board, or (iii) if the Common Stock is not quoted on the OTC Bulletin Board, a day on which the Common Stock is quoted in the over-the-counter market as reported by Pink Sheets LLC (formerly the National Quotation Bureau Incorporated) (or any similar organization or agency succeeding to its functions of reporting prices); provided, that in the event that the Common Stock is not listed or quoted as set forth in (i), (ii) and (iii) above, then Trading Day shall mean a Business Day.

"TRADING MARKET" means whichever of the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market or the Nasdaq SmallCap Market that the Common Stock is listed or quoted for trading on the date in question.

"TRANSACTION DOCUMENTS" means this Agreement, the Debentures, the Security Agreement, the Intellectual Property Security Agreement, the Warrants, the Registration Rights Agreement, the Transfer Agent Instructions and any other documents or agreements executed in connection with the transactions contemplated hereunder.

"TRANSFER AGENT INSTRUCTIONS" means the Company's Transfer Agent Instructions in the form of Exhibit F.

"UNDERLYING SHARES" means the shares of Common Stock issuable in respect of the Debentures, including the shares of Common Stock issuable in respect of interest on the Debentures.

"WARRANTS" means First Warrants, the Second Warrants and the Third Warrants.

"WARRANT SHARES" means the shares of Common Stock issuable upon exercise of the Warrants.

ARTICLE II. PURCHASE AND SALE

2.1 Closing. Subject to the terms and conditions set forth in this

Agreement, at the Closing the Company shall issue and sell to each Purchaser, and each Purchaser shall, severally and not jointly, purchase from the Company, the Debentures and the Warrants, for the aggregate purchase price set forth below each Purchaser's address on the signature pages to this Agreement. The Closing shall take place at the offices of Bryan Cave LLP, 1290 Avenue of the Americas, New York, NY 10104 on the date hereof or at such other location or time as the parties may agree.

2.2 Closing Deliveries. (a) At the Closing, the Company shall deliver or

cause to be delivered to each Purchaser the following:

(i) this Agreement duly executed by the Company;

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(ii) a Debenture, registered in the name of such Purchaser, evidencing the principal amount of Debentures purchased by such Purchaser, which amount is such Purchaser's Investment Amount;

(iii) a certificate evidencing a number of shares of Common Stock equal to (x) 387,301 times (y) such Purchaser's Purchaser Percentage, registered in the name of such Purchaser, which amount represents the payment of interest, at the rate of 9% per annum, on the outstanding principal amount of the Debentures for the first nine months following the Closing Date;

(iv) a First Warrant, registered in the name of such Purchaser, pursuant to which such Purchaser shall have the right to acquire the number of shares of Common Stock equal to (x) 1,166,700 times (y) such Purchaser's Purchaser Percentage, at an exercise price of \$.84 per share;

(v) a Second Warrant, registered in the name of such Purchaser, pursuant to which such Purchaser shall have the right to acquire the number of shares of Common Stock equal to (x) 1,166,700 times (y) such Purchaser's Purchaser Percentage, at an exercise price of \$.89 per share;

(vi) a Third Warrant, registered in the name of such Purchaser, pursuant to which such Purchaser shall have the right to acquire the number of shares of Common Stock equal to (x) 1,166,700 times such Purchaser's Purchaser Percentage, at an exercise price of \$.93 per share;

(vii) the legal opinion of Company Counsel, in agreed form, addressed to the Purchasers;

(viii) the Registration Rights Agreement duly executed by the Company;

(ix) the Security Agreement duly executed by the Company and the subsidiaries of the Company party thereto;

(x) the Intellectual Property Security Agreement duly executed by the Company and the subsidiaries of the Company party thereto; and

(xi) the Transfer Agent Instructions executed by the Company and delivered to and acknowledged by the Company's transfer agent.

(b) At the Closing, each Purchaser shall deliver or cause to be delivered to the Company the following:

(i) this Agreement duly executed by such Purchaser;

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(ii) such Purchaser's Investment Amount, in United States dollars and in immediately available funds, by wire transferr to an account designated in writing by the Company for such purpose;

(iii) the Security Agreement duly executed by such Purchaser;

(iv) the Intellectual Property Security Agreement duly executed by such Purchaser; and

(v) the Registration Rights Agreement duly executed by such Purchaser.

ARTICLE III. REPRESENTATIONS AND WARRANTIES

5.1. Representations and Warranties of the Company. The Company hereby

makes the following representations and warranties to each Purchaser:

(a) Subsidiaries. The Company has no direct or indirect Subsidiaries other

 than those listed in Schedule 3.1(a). Except as disclosed in Schedule 3.1(a),

 the Company owns, directly or indirectly, all of the capital stock of each
 Subsidiary free and clear of any and all Liens, and all the issued and
 outstanding shares of capital stock of each Subsidiary are validly issued and
 are fully paid, non-assessable and free of preemptive and similar rights.

(b) Organization and Qualification. Each of the Company and each Subsidiary

 is an entity duly incorporated or otherwise organized, validly existing and in
 good standing under the laws of the jurisdiction of its incorporation or
 organization (as applicable), with the requisite power and authority to own and
 use its properties and assets and to carry on its business as currently
 conducted. Neither the Company nor any Subsidiary is in violation of any of the
 provisions of its respective certificate or articles of incorporation, bylaws or
 other organizational or charter documents. Each of the Company and each
 Subsidiary is duly qualified to conduct business and is in good standing as a
 foreign corporation or other entity in each jurisdiction in which the nature of
 the business conducted or property owned by it makes such qualification
 necessary, except where the failure to be so qualified or in good standing, as
 the case may be, could not, individually or in the aggregate, have or reasonably
 be expected to result in (i) an adverse effect on the legality, validity or
 enforceability of any Transaction Document, (ii) a material and adverse effect
 on the results of operations, assets, business or financial condition of the
 Company and the Subsidiaries, taken as a whole, or (iii) an adverse impairment
 to the Company's ability to perform on a timely basis its obligations under any
 Transaction Document (any of (i), (ii) or (iii), a "MATERIAL ADVERSE EFFECT").

(c) Authorization; Enforcement. The Company has the requisite corporate

 power and authority to enter into and to consummate the transactions
 contemplated by each of the Transaction Documents and otherwise to carry out its
 obligations thereunder. The execution and delivery of each of the Transaction
 Documents by the Company and the consummation by it of the transactions
 contemplated thereby have been duly authorized by all necessary action on the
 part of the Company and no further action is required by the Company in
 connection therewith. Each Transaction Document has been (or upon delivery will

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have been) duly executed by the Company and, when delivered in accordance with
 the terms hereof, will constitute the valid and binding obligation of the
 Company enforceable against the Company in accordance with its terms, except (a)
 as such enforceability may be limited by bankruptcy, insolvency, reorganization
 or similar laws affecting creditors' rights generally, (b) as enforceability of
 any indemnification and contribution provisions may be limited under the federal
 and state securities laws and public policy, and (c) that the remedy of specific
 performance and injunctive and other forms of equitable relief may be subject to
 equitable defenses and to the discretion of the court before which any
 proceeding therefor may be brought.

(d) No Conflicts. The execution, delivery and performance of the

 Transaction Documents by the Company and the consummation by the Company of the
 transactions contemplated thereby do not and will not (i) conflict with or
 violate any provision of the Company's or any Subsidiary's certificate or
 articles of incorporation, bylaws or other organizational or charter documents,
 or (ii) conflict with, or constitute a default (or an event that with notice or
 lapse of time or both would become a default) under, or give to others any
 rights of termination, amendment, acceleration or cancellation (with or without
 notice, lapse of time or both) of, any agreement, credit facility, debt or other

instrument (evidencing a Company or Subsidiary debt or otherwise) or other understanding to which the Company or any Subsidiary is a party or by which any property or asset of the Company or any Subsidiary is bound or affected, or (iii) result in a violation of any law, rule, regulation, order, judgment, injunction, decree or other restriction of any court or governmental authority to which the Company or a Subsidiary is subject (including federal and state securities laws and regulations), or by which any property or asset of the Company or a Subsidiary is bound or affected; except in the case of each of clauses (ii) and (iii), such as could not, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect.

(e) Filings, Consents and Approvals. Neither the Company nor any Subsidiary

is required to obtain any consent, waiver, authorization or order of, give any notice to, or make any filing or registration (collectively, "CONSENTS") with, any court or other federal, state, local or other governmental authority or other Person in connection with the execution, delivery and performance by the Company of the Transaction Documents, other than (i) the filing of appropriate UCC financing statements with the appropriate states and other authorities pursuant to the Security Agreement and the Intellectual Property Security Agreement, (ii) the filing with the Commission of one or more Registration Statements in accordance with the requirements of the Registration Rights Agreement, (iii) the application(s) to the Nasdaq National Market for the listing of the Underlying Shares and Warrant Shares for trading thereon if and in the time and manner required thereby, (iv) all filings required pursuant to Section 4.5 hereof, and (v) those Consents set forth in Schedule 3.1(e), which

Consents have been obtained prior to the date hereof.

(f) Issuance of the Securities. The Securities have been duly authorized

and, when issued and paid for in accordance with the Transaction Documents, will be duly and validly issued, fully paid and nonassessable, free and clear of all Liens. The Company has reserved from its duly authorized capital stock the maximum number of shares of Common Stock issuable pursuant to the Debentures and the Warrants in order to issue the full number of Underlying Shares and Warrant

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Shares as are or may become issuable in accordance with the terms of the Debentures and Warrants.

(g) Capitalization. The number of shares and type of all authorized, issued

and outstanding capital stock of the Company is set forth in Schedule 3.1(g).

Except as set forth in Schedule 3.1(g), no securities of the Company are

entitled to preemptive or similar rights, and no Person has any right of first refusal, preemptive right, right of participation, or any similar right to participate in the transactions contemplated by the Transaction Documents. Except as a result of the purchase and sale of the Securities and except as disclosed in Schedule 3.1(g), there are no outstanding options, warrants, scrip

rights to subscribe to, calls or commitments of any character whatsoever relating to, or securities, rights or obligations convertible into or exchangeable for, or giving any Person any right to subscribe for or acquire, any shares of Common Stock, or contracts, commitments, understandings or arrangements by which the Company or any Subsidiary is or may become bound to issue additional shares of Common Stock, or securities or rights convertible or exchangeable into shares of Common Stock. Except as set forth in Schedule

3.1(g), the issue and sale of the Securities will not, immediately or with the

passage of time, obligate the Company to issue shares of Common Stock or other securities to any Person (other than the Purchasers) and will not result in a right of any holder of Company securities to adjust the exercise, conversion, exchange or reset price under such securities.

(h) SEC Reports; Financial Statements. The Company has filed all reports

required to be filed by it under the Securities Act and the Exchange Act, including pursuant to Section 13(a) or 15(d) thereof, for the two years preceding the date hereof (or such shorter period as the Company was required by law to file such reports) (the foregoing materials being collectively referred to herein as the "SEC REPORTS" and, together with the Schedules to this Agreement, the "DISCLOSURE MATERIALS") on a timely basis or has received a valid extension of such time of filing and has filed any such SEC Reports prior to the expiration of any such extension. The Company has delivered to the Purchasers a copy of all SEC Reports filed within the 10 days preceding the date hereof. As of their respective dates, the SEC Reports complied in all material respects with the requirements of the Securities Act and the Exchange Act and the rules and regulations of the Commission promulgated thereunder, and none of the SEC Reports, when filed, contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading. The Company is in compliance with the Sarbanes-Oxley Act of 2002, and the rules and regulations promulgated thereunder by all government and regulatory authorities and agencies. The financial statements of the Company included in the SEC Reports comply in all material respects with applicable accounting requirements and the rules and regulations of the Commission with respect thereto as in effect at the time of filing. Such financial statements have been prepared in accordance with generally accepted accounting principles applied on a consistent basis during the periods involved ("GAAP"), except as may be otherwise specified in such financial statements or the notes thereto, and fairly present in all material respects the financial position of the Company and its consolidated Subsidiaries as of and for the dates thereof and the results of operations and cash flows for the periods then ended, subject, in the case of unaudited statements, to normal, immaterial, year-end audit adjustments.

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(i) Material Changes. Since the date of the latest audited financial

statements included within the SEC Reports, except as specifically disclosed in the SEC Reports, (i) there has been no event, occurrence or development that has had or that could reasonably be expected to result in a Material Adverse Effect, (ii) the Company has not incurred any liabilities (contingent or otherwise) other than (A) trade payables and accrued expenses incurred in the ordinary course of business consistent with past practice and (B) liabilities not required to be reflected in the Company's financial statements pursuant to GAAP or required to be disclosed in filings made with the Commission, (iii) the Company has not altered its method of accounting or the identity of its auditors, (iv) the Company has not declared or made any dividend or distribution of cash or other property to its stockholders or purchased, redeemed or made any agreements to purchase or redeem any shares of its capital stock, and (v) the Company has not issued any equity securities to any officer, director or Affiliate, except pursuant to existing Company stock option plans. The Company does not have pending before the Commission any request for confidential treatment of information.

(j) Litigation. Except as set forth in Schedule 3.1(j), there is no Action

which (i) adversely affects or challenges the legality, validity or enforceability of any of the Transaction Documents or the Securities or (ii) could, if there were an unfavorable decision, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect. Neither the Company nor any Subsidiary, nor any director or officer thereof, is or has been the subject of any Action involving a claim of violation of or liability under federal or state securities laws or a claim of breach of fiduciary duty. There has not been, and to the knowledge of the Company, there is not pending or contemplated, any investigation by the Commission involving the Company or any current or former director or officer of the Company. The Commission has not issued any stop order or other order suspending the effectiveness of any registration statement filed by the Company or any Subsidiary under the Exchange Act or the Securities Act.

(k) Labor Relations. No material labor dispute exists or, to the knowledge

of the Company, is imminent with respect to any of the employees of the Company.

(l) Compliance. Neither the Company nor any Subsidiary (i) is in default

under or in violation of (and no event has occurred that has not been waived that, with notice or lapse of time or both, would result in a default by the Company or any Subsidiary under), nor has the Company or any Subsidiary received notice of a claim that it is in default under or that it is in violation of, any indenture, loan or credit agreement or any other agreement or instrument to which it is a party or by which it or any of its properties is bound (whether or not such default or violation has been waived), (ii) is in violation of any order of any court, arbitrator or governmental body, or (iii) is or has been in violation of any statute, rule or regulation of any governmental authority, including without limitation all foreign, federal, state and local laws relating to taxes, environmental protection, occupational health and safety, product quality and safety and employment and labor matters, except in each case as could not, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect.

(m) Regulatory Permits. The Company and the Subsidiaries possess all

certificates, authorizations and permits issued by the appropriate federal, state, local or foreign regulatory authorities necessary to conduct their respective businesses as described in the SEC Reports, except where the failure to possess such permits would not, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect ("MATERIAL PERMITS"), and neither the Company nor any Subsidiary has received any notice of proceedings relating to the revocation or modification of any Material Permit.

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(n) Title to Assets. The Company and the Subsidiaries have good and

marketable title in fee simple to all real property owned by them that is material to their respective businesses and good and marketable title in all personal property owned by them that is material to their respective businesses, in each case free and clear of all Liens, except as set forth in Schedule 3.1(n)

and except for Liens as do not materially affect the value of such property and do not materially interfere with the use made and proposed to be made of such property by the Company and the Subsidiaries. Any real property and facilities held under lease by the Company and the Subsidiaries are held by them under valid, subsisting and enforceable leases of which the Company and the Subsidiaries are in compliance in all material respects.

(o) Patents and Trademarks. The Company and the Subsidiaries have, or have

rights to use, all patents, patent applications, trademarks, trademark applications, service marks, trade names, copyrights, licenses and other similar rights that are necessary or material for use in connection with their respective businesses as described in the SEC Reports and which the failure to so have could, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect (collectively, the "INTELLECTUAL PROPERTY RIGHTS"). Neither the Company nor any Subsidiary has received a written notice that the Intellectual Property Rights used by the Company or any Subsidiary violates or infringes upon the rights of any Person. Except as set forth in the SEC Reports, to the knowledge of the Company, all such Intellectual Property Rights are enforceable and there is no existing infringement by another Person of any of the Intellectual Property Rights.

(p) Insurance. The Company and the Subsidiaries are insured by insurers of

 recognized financial responsibility against such losses and risks and in such amounts as are prudent and customary in the businesses in which the Company and the Subsidiaries are engaged. The Company has no reason to believe that it will not be able to renew its existing insurance coverage as and when such coverage expires or to obtain similar coverage from similar insurers as may be necessary to continue its business without a significant increase in cost, other than anticipated increases in the market price of officers' and directors' liability insurance generally.

(q) Transactions With Affiliates and Employees. Except as set forth in the

 SEC Reports, none of the officers or directors of the Company and, to the knowledge of the Company, none of the employees of the Company is presently a party to any transaction with the Company or any Subsidiary (other than for services as employees, officers and directors), including any contract, agreement or other arrangement providing for the furnishing of services to or by, providing for rental of real or personal property to or from, or otherwise requiring payments to or from any officer, director or such employee or, to the knowledge of the Company, any entity in which any officer, director, or any such employee has a substantial interest or is an officer, director, trustee or partner.

(r) Internal Accounting Controls. The Company and the Subsidiaries maintain

 a system of internal accounting controls which the audit committee of the board of directors reasonably believes is sufficient to provide reasonable assurance that (i) transactions are executed in accordance with management's general or

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specific authorizations, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain asset accountability, (iii) access to assets is permitted only in accordance with management's general or specific authorization, and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

(s) Solvency. Based on the financial condition of the Company as of the

 Closing Date, (i) the Company's fair saleable value of its assets exceeds the amount that will be required to be paid on or in respect of the Company's existing debts and other liabilities (including known contingent liabilities) as they mature; (ii) the Company's assets do not constitute unreasonably small capital to carry on its business for the current fiscal year as now conducted and as proposed to be conducted including its capital needs taking into account the particular capital requirements of the business conducted by the Company,

and projected capital requirements and capital availability thereof; and (iii) the current cash flow of the Company, together with the proceeds the Company would receive, were it to liquidate all of its assets, after taking into account all anticipated uses of the cash, would be sufficient to pay all amounts on or in respect of its debt when such amounts are required to be paid. The Company does not intend to incur debts beyond its ability to pay such debts as they mature (taking into account the timing and amounts of cash to be payable on or in respect of its debt).

(t) Certain Fees. Except as described in Schedule 3.1(t), no brokerage or

finder's fees or commissions are or will be payable by the Company to any broker, financial advisor or consultant, finder, placement agent, investment banker, bank or other Person with respect to the transactions contemplated by this Agreement. The Purchasers shall have no obligation with respect to any fees or with respect to any claims (other than such fees or commissions owed by a Purchaser pursuant to written agreements executed by such Purchaser which fees or commissions shall be the sole responsibility of such Purchaser) made by or on behalf of other Persons for fees of a type contemplated in this Section that may be due in connection with the transactions contemplated by this Agreement.

(u) Certain Registration Matters. Assuming the accuracy of the Purchasers'

representations and warranties set forth in Section 3.2(b)-(f), no registration under the Securities Act is required for the offer and sale of the Underlying Shares and Warrant Shares by the Company to the Purchasers as contemplated by the Transaction Documents. The Company is eligible to register the resale of its Common Stock for resale by the Purchasers under Form S-3 promulgated under the Securities Act. Except as described in Schedule 3.1(u), the Company has not

granted or agreed to grant to any Person any rights (including "piggy-back" registration rights) to have any securities of the Company registered with the Commission or any other governmental authority that have not been satisfied.

(v) Listing and Maintenance Requirements. Except as set forth in the SEC

Reports or as set forth in Schedule 3.1(v), the Company has not, in the two

years preceding the date hereof, received notice (written or oral) from any Trading Market on which the Common Stock is or has been listed or quoted to the effect that the Company is not in compliance with the listing or maintenance requirements of such Trading Market. Except for the maintenance of the \$1.00 minimum bid price (pursuant to the rules and regulations of the Nasdaq Stock Market), the Company is currently in compliance with all such listing and maintenance requirements. The issuance and sale of the Securities hereunder does not contravene the rules and regulations of the Trading Market and no approval

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of the shareholders of the Company is required for the Company to issue and deliver to the Purchasers the maximum number of shares of Common Stock contemplated by this Agreement, including by reason of the issuance of shares of Common Stock upon conversion in full of the Debentures and the issuance of the Warrant Shares upon exercise in full of the Warrants.

(w) Investment Company. The Company is not, and is not an Affiliate of, an

"investment company" within the meaning of the Investment Company Act of 1940, as amended.

(x) Application of Takeover Protections. The Company has taken all

necessary action, if any, in order to render inapplicable any control share

acquisition, business combination, poison pill (including any distribution under a rights agreement) or other similar anti-takeover provision under the Company's Certificate of Incorporation (or similar charter documents) or the laws of its state of incorporation that is or could become applicable to the Purchasers solely as a result of the Purchasers and the Company fulfilling their obligations or exercising their rights under the Transaction Documents, including without limitation the Company's issuance of the Securities and the Purchasers' ownership of the Securities.

(y) Ranking of Debentures. Except as set forth on Schedule 3.1(y), no

Indebtedness of the Company is senior to or ranks pari passu with the Debentures in right of payment, whether with respect of payment of redemptions, interest, damages or upon liquidation or dissolution or otherwise.

(z) Disclosure. The Company confirms that neither it nor any Person acting

on its behalf has provided any of the Purchasers or their agents or counsel with any information that the Company believes constitutes material, non-public information. The Company understands and confirms that the Purchasers will rely on the foregoing representations and covenants in effecting transactions in securities of the Company. All disclosure provided to the Purchasers regarding the Company, its business and the transactions contemplated hereby, furnished by or on behalf of the Company (including the Company's representations and warranties set forth in this Agreement) are true and correct and do not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading.

3.4 Representations and Warranties of the Purchasers. Each Purchaser

hereby, for itself and for no other Purchaser, represents and warrants to the Company as follows:

(a) Organization; Authority. Such Purchaser is an entity duly organized,

validly existing and in good standing under the laws of the jurisdiction of its organization with the requisite corporate or partnership power and authority to enter into and to consummate the transactions contemplated by the applicable Transaction Documents and otherwise to carry out its obligations thereunder. The execution, delivery and performance by such Purchaser of the transactions contemplated by this Agreement has been duly authorized by all necessary corporate or partnership action on the part of such Purchaser. Each Transaction Document to which such Purchaser is a party has been duly executed by such Purchaser, and when delivered by such Purchaser in accordance with the terms hereof, will constitute the valid and legally binding obligation of such

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Purchaser, enforceable against it in accordance with its terms, except (a) as such enforceability may be limited by bankruptcy, insolvency, reorganization or similar laws affecting creditors' rights generally, (b) as enforceability of any indemnification and contribution provisions may be limited under the federal and state securities laws and public policy, and (c) that the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any proceeding therefor may be brought.

(b) Investment Intent. Such Purchaser is acquiring the Securities as

principal for its own account for investment purposes only and not with a view to or for distributing or reselling such Securities or any part thereof, without prejudice, however, to such Purchaser's right at all times to sell or otherwise dispose of all or any part of such Securities in compliance with applicable

federal and state securities laws. Nothing contained herein shall be deemed a representation or warranty by such Purchaser to hold the Securities for any period of time. Such Purchaser is acquiring the Securities hereunder in the ordinary course of its business. Such Purchaser does not have any agreement or understanding, directly or indirectly, with any Person to distribute any of the Securities.

(c) Purchaser Status. At the time such Purchaser was offered the

Securities, it was, and at the date hereof it is, and on each date on which it exercises the Warrants it will be, an "accredited investor" as defined in Rule 501(a) under the Securities Act. Such Purchaser is not a registered broker-dealer under Section 15 of the Exchange Act.

(d) Experience of such Purchaser. Such Purchaser, either alone or together

with its representatives, has such knowledge, sophistication and experience in business and financial matters so as to be capable of evaluating the merits and risks of the prospective investment in the Securities, and has so evaluated the merits and risks of such investment. Such Purchaser is able to bear the economic risk of an investment in the Securities and, at the present time, is able to afford a complete loss of such investment.

(e) General Solicitation. Such Purchaser is not purchasing the Securities

as a result of any advertisement, article, notice or other communication regarding the Securities published in any newspaper, magazine or similar media or broadcast over television or radio or presented at any seminar or any other general solicitation or general advertisement.

(f) Access to Information. Such Purchaser acknowledges that it has reviewed

the Disclosure Materials and has been afforded (i) the opportunity to ask such questions as it has deemed necessary of, and to receive answers from, representatives of the Company concerning the terms and conditions of the offering of the Securities and the merits and risks of investing in the Securities; (ii) access to information about the Company and the Subsidiaries and their respective financial condition, results of operations, business, properties, management and prospects sufficient to enable it to evaluate its investment; and (iii) the opportunity to obtain such additional information that the Company possesses or can acquire without unreasonable effort or expense that is necessary to make an informed investment decision with respect to the investment. Neither such inquiries nor any other investigation conducted by or on behalf of such Purchaser or its representatives or counsel shall modify, amend or affect such Purchaser's right to rely on the truth, accuracy and completeness of the Disclosure Materials and the Company's representations and warranties contained in the Transaction Documents.

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The Company acknowledges and agrees that each Purchaser does not make or has not made any representations or warranties with respect to the transactions contemplated hereby other than those specifically set forth in this Section 3.2.

ARTICLE IV. OTHER AGREEMENTS OF THE PARTIES

4.1 Transfer Restrictions. (a) Securities may only be disposed of in

compliance with state and federal securities laws. In connection with any transfer of the Securities other than pursuant to an effective registration

statement, to the Company, to an Affiliate of a Purchaser or in connection with a pledge as contemplated in Section 4.1(b), the Company may require the transferor thereof to provide to the Company an opinion of counsel selected by the transferor, the form and substance of which opinion shall be reasonably satisfactory to the Company, to the effect that such transfer does not require registration of such transferred Securities under the Securities Act.

(b) Certificates evidencing the Securities will contain the following legend, so long as is required by this Section 4.1(c):

 [NEITHER] THESE SECURITIES [NOR THE SECURITIES ISSUABLE UPON [EXERCISE][CONVERSION] OF THESE SECURITIES] HAVE [NOT] BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE SECURITIES COMMISSION OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS AS EVIDENCED BY A LEGAL OPINION OF COUNSEL TO THE TRANSFEROR TO SUCH EFFECT, THE SUBSTANCE OF WHICH SHALL BE REASONABLY ACCEPTABLE TO THE COMPANY. THESE SECURITIES AND THE SECURITIES ISSUABLE UPON EXERCISE OF THESE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN SECURED BY SUCH SECURITIES.

The Company acknowledges and agrees that a Purchaser may from time to time pledge pursuant to a bona fide margin agreement or grant a security interest in some or all of the Securities and, if required under the terms of such arrangement, such Purchaser may transfer pledged or secured Securities to the pledgees or secured parties. Such a pledge or transfer would not be subject to approval or consent of the Company and no legal opinion of legal counsel to the pledgee, secured party or pledgor shall be required in connection therewith. Further, no notice shall be required of such pledge. At the appropriate Purchaser's expense, the Company will execute and deliver such reasonable documentation as a pledgee or secured party of Securities may reasonably request in connection with a pledge or transfer of the Securities including the preparation and filing of any required prospectus supplement under Rule 424(b)(3) of the Securities Act or other applicable provision of the Securities Act to appropriately amend the list of Selling Stockholders thereunder.

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(c) Certificates evidencing the Underlying Shares and Warrant Shares shall not contain any legend (including the legend set forth in Section 4.1(b)): (i) while a registration statement (including the Registration Statement) covering the resale of such Underlying Shares and Warrant Shares is effective under the Securities Act, or (ii) following any sale of such Underlying Shares or Warrant Shares pursuant to Rule 144, or (iii) if such Underlying Shares or Warrant Shares are eligible for sale under Rule 144(k), or (iv) if such legend is not required under applicable requirements of the Securities Act (including judicial interpretations and pronouncements issued by the Staff of the Commission). The Company shall cause its counsel to issue the legal opinion included in the Transfer Agent Instructions to the Company's transfer agent on the Effective Date. Following the Effective Date or at such earlier time as a legend is no longer required for the Underlying Shares and Warrant Shares under this Section 4.1(c), the Company will, no later than three Trading Days following the delivery by a Purchaser to the Company or the Company's transfer agent of a certificate representing Underlying Shares or Warrant Shares containing a restrictive legend, deliver or cause to be delivered to such Purchaser a certificate representing such Underlying Shares or Warrant Shares that is free from all restrictive and other legends. The Company may not make any notation on its records or give instructions to any transfer agent of

the Company that enlarge the restrictions on transfer set forth in this Section.

4.2 Furnishing of Information. As long as any Purchaser owns the

 Securities, the Company covenants to timely file (or obtain extensions in respect thereof and file within the applicable grace period) all reports required to be filed by the Company after the date hereof pursuant to the Exchange Act. Upon the request of any such Person, the Company shall deliver to such Person a written certification of a duly authorized officer as to whether it has complied with the preceding sentence. As long as any Purchaser owns Securities, if the Company is not required to file reports pursuant to such laws, it will prepare and furnish to the Purchasers and make publicly available in accordance with Rule 144(c) such information as is required for the Purchasers to sell the Underlying Shares and Warrant Shares under Rule 144. The Company further covenants that it will take such further action as any holder of Securities may reasonably request, all to the extent required from time to time to enable such Person to sell such Underlying Shares and Warrant Shares without registration under the Securities Act within the limitation of the exemptions provided by Rule 144.

4.3 Integration. The Company shall not, and shall use its best efforts to

 ensure that no Affiliate of the Company shall, sell, offer for sale or solicit offers to buy or otherwise negotiate in respect of any security (as defined in Section 2 of the Securities Act) that would be integrated with the offer or sale of the Securities in a manner that would require the registration under the Securities Act of the sale of the Securities to the Purchasers, or that would be integrated with the offer or sale of the Securities for purposes of the rules and regulations of any Trading Market.

4.4 Subsequent Registrations and Subsequent Placements.

 (a) Prior to the Effective Date, the Company shall not file a registration statement (including any shelf registration statements) (other than on Form S-8 or pursuant to the Registration Rights Agreement) with the Commission with respect to any securities of the Company (other than pre-effective amendments to Registration Statement Nos. 333-99559 and 333-99673).

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(b) Prior to the expiration of the first anniversary of the Effective Date, the Company will not, directly or indirectly, offer, sell, grant any option to purchase, or otherwise dispose of (or announce any offer, sale, grant or any option to purchase or other disposition of) any of Common Stock or Common Stock Equivalents or any of its Subsidiaries' equity or Common Stock Equivalents, including without limitation, pursuant to a private placement, an equity line of credit or a shelf registration statement in accordance with Rule 415 under the Securities Act, (such offer, sale, grant, disposition or announcement being referred to as "SUBSEQUENT PLACEMENT"), unless: (i) the Company delivers to each Purchaser a written notice (the "SUBSEQUENT PLACEMENT NOTICE") of its intention to effect such Subsequent Placement, which Subsequent Placement Notice shall describe in reasonable detail the proposed terms of such Subsequent Placement, the amount of proceeds intended to be raised thereunder, the Person with whom such Subsequent Placement is proposed to be effected, and attached to which shall be a term sheet or similar document relating thereto and (ii) such Purchaser shall not have notified the Company by 6:30 p.m. (New York City time) on the seventh Trading Day after (but not including) its receipt of the Subsequent Placement Notice of its willingness to provide (or to cause its designee to provide), subject to completion of mutually acceptable documentation, all or part of such financing to the Company on the same terms set forth in the Subsequent Placement Notice. If the Purchasers shall fail to

so notify the Company of their willingness to participate in full in the Subsequent Placement, the Company may effect the remaining portion of such Subsequent Placement on the terms and to the Persons set forth in the Subsequent Placement Notice. The Company shall provide the Purchasers with a second Subsequent Placement Notice and the Purchasers will again have the right of first refusal set forth in this Section 4.4(b), if the Subsequent Placement subject to the initial Subsequent Placement Notice is not consummated for any reason on the terms set forth in such Subsequent Notice within 30 Trading Days after the date of the initial Subsequent Placement Notice with the Person identified in the Subsequent Placement Notice. If the Purchasers indicate a willingness to provide financing in excess of the amount set forth in the Subsequent Placement Notice, then each Purchaser will be entitled to provide financing pursuant to such Subsequent Placement Notice up to an amount equal to such Purchaser Percentage of the financing, but the Company shall not be required to accept financing from the Purchasers in an amount in excess of the amount set forth in the Subsequent Placement Notice.

(c) The restrictive period set forth in the first sentence of Section 4.4(b) shall be extended for the number of Trading Days during such period in which (i) trading in the Common Stock is suspended by any Trading Market, or (ii) following the Effective Date, the Registration Statement is not effective or the prospectus included in the Registration Statement may not be used by the Purchasers for the resale of the Underlying Shares and the Warrant Shares.

(d) The restrictions contained in Sections 4.4(b) shall not apply to any grant or issuance by the Company of any of the following: (i) the issuance of securities upon the exercise or conversion of any Common Stock Equivalents issued by the Company prior to the date of this Agreement and listed on Schedule 3.1(g), and (ii) the grant of options or warrants, or the issuance of additional

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securities, under any duly authorized Company stock option, restricted stock plan or stock purchase plan in existence on the Closing Date (but not as to any amendments or other modifications to the number of Common Stock issuable thereunder, the terms set forth therein, or the exercise price set forth therein).

4.5 Securities Laws Disclosure; Publicity. The Company shall no later than

January 6, 2003, (x) issue a press release reasonably acceptable to the Purchasers disclosing the transactions contemplated hereby and (y) file a Current Report on Form 8-K disclosing the transactions contemplated hereby, and shall make such other filings and notices in the manner and time required by the Commission. Notwithstanding the foregoing, the Company shall not publicly disclose the name of any Purchaser, or include the name of any Purchaser in any filing with the Commission or any regulatory agency or Trading Market, without the prior written consent of such Purchaser, except to the extent such disclosure is required by law or Trading Market regulations, in which case the Company shall provide the Purchasers with prior notice of such disclosure.

4.6 Indemnification of Purchasers. The Company will indemnify and hold the

Purchasers and their directors, officers, shareholders, partners, employees and agents (each, a "PURCHASER PARTY") harmless from any and all losses, liabilities, obligations, claims, contingencies, damages, costs and expenses, including all judgments, amounts paid in settlements, court costs and reasonable attorneys' fees and costs of investigation (collectively, "LOSSES") that any such Purchaser Party may suffer or incur as a result of or relating to (a) any misrepresentation, breach or inaccuracy, or any allegation by a third party that, if true, would constitute a breach or inaccuracy, of any of the

representations, warranties, covenants or agreements made by the Company in any Transaction Document; or (b) any Action brought or made against such Purchaser Party and solely arising out of or resulting from the execution, delivery, performance or enforcement of this Agreement or any of the other Transaction Documents. In addition to the indemnity contained herein, the Company will reimburse each Purchaser Party for its reasonable legal and other expenses (including the cost of any investigation, preparation and travel in connection therewith) incurred in connection therewith, as such expenses are incurred.

4.7 Shareholders Rights Plan. No claim will be made or enforced by the

Company or any other Person that any Purchaser is an "Acquiring Person" under any shareholders rights plan or similar plan or arrangement in effect or hereafter adopted by the Company, or that any Purchaser could be deemed to trigger the provisions of any such plan or arrangement, by virtue of receiving the Securities under the Transaction Documents or under any other agreement between the Company and the Purchasers.

4.8 Non-Public Information. The Company covenants and agrees that neither

it nor any other Person acting on its behalf will provide any Purchaser or its agents or counsel with any information that the Company believes constitutes material non-public information, unless prior thereto such Purchaser shall have executed a written agreement regarding the confidentiality and use of such information. The Company understands and confirms that each Purchaser shall be relying on the foregoing representations in effecting transactions in securities of the Company.

4.9 Use of Proceeds. The Company shall use the net proceeds from the sale

of the Securities hereunder for working capital purposes and not for the satisfaction of any portion of the Company's debt (other than payment of trade

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receivables and accrued expenses in the ordinary course of the Company's business and consistent with prior practices), to redeem any Company equity or equity-equivalent securities or to settle any outstanding litigation.

4.10 Secured Obligation. The payment obligations under the Debentures are

secured pursuant to the Security Agreement and the Intellectual Property Security Agreement.

ARTICLE V. MISCELLANEOUS

5.1. Fees and Expenses. At the Closing, the Company shall reimburse the

Purchasers for their legal fees and expenses in connection with the preparation and negotiation of the Transaction Documents by paying \$32,500 to Bryan Cave LLP. Except as specified in the immediately preceding sentence and as contemplated in the Registration Rights Agreement, each party shall pay the fees and expenses of its advisers, counsel, accountants and other experts, if any, and all other expenses incurred by such party incident to the negotiation, preparation, execution, delivery and performance of this Agreement. The Company shall pay all stamp and other taxes and duties levied in connection with the sale of the Securities. In addition to the foregoing, the Company shall pay the fees described in Schedule 3.1(t) no later than January 3, 2003.

5.2 Entire Agreement. The Transaction Documents, together with the Exhibits

and Schedules thereto, contain the entire understanding of the parties with

respect to the subject matter hereof and supersede all prior agreements and understandings, oral or written, with respect to such matters, which the parties acknowledge have been merged into such documents, exhibits and schedules.

5.3 Notices. Any and all notices or other communications or deliveries

required or permitted to be provided hereunder shall be in writing and shall be deemed given and effective on the earliest of (a) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section prior to 6:30 p.m. (New York City time) on a Trading Day, (b) the next Trading Day after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section on a day that is not a Trading Day or later than 6:30 p.m. (New York City time) on any Trading Day, (c) the Trading Day following the date of mailing, if sent by U.S. nationally recognized overnight courier service, or (d) upon actual receipt by the party to whom such notice is required to be given. The address for such notices and communications shall be as follows:

If to the Company: Electric Fuel Corporation
 632 Broadway
 Suite 301
 New York, NY 10012
 Facsimile No.: (212) 529-5800
 Attn: Chief Financial Officer and General
 Counsel

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With a copy to: Electric Fuel (E.F.L.) Ltd.
 Western Industrial Zone
 Beit Shemesh 99000, Israel
 Facsimile No.: 011-972-2-990-6688
 Attn.: Chief Financial Officer and General
 Counsel

If to a Purchaser: To the address set forth under such Purchaser's
 name on the signature pages hereof;

or such other address as may be designated in writing hereafter, in the same manner, by such Person.

5.4 Amendments; Waivers. No provision of this Agreement may be waived or

amended except in a written instrument signed, in the case of an amendment, by the Company and each of the Purchasers or, in the case of a waiver, by the party against whom enforcement of any such waiver is sought. No waiver of any default with respect to any provision, condition or requirement of this Agreement shall be deemed to be a continuing waiver in the future or a waiver of any subsequent default or a waiver of any other provision, condition or requirement hereof, nor shall any delay or omission of either party to exercise any right hereunder in any manner impair the exercise of any such right.

5.5 Construction. The headings herein are for convenience only, do not

constitute a part of this Agreement and shall not be deemed to limit or affect any of the provisions hereof. The language used in this Agreement will be deemed to be the language chosen by the parties to express their mutual intent, and no rules of strict construction will be applied against any party. This Agreement shall be construed as if drafted jointly by the parties, and no presumption or burden of proof shall arise favoring or disfavoring any party by virtue of the authorship of any provisions of this Agreement or any of the Transaction Documents.

5.6 Successors and Assigns. This Agreement shall be binding upon and inure

to the benefit of the parties and their successors and permitted assigns. The Company may not assign this Agreement or any rights or obligations hereunder without the prior written consent of the Purchasers. Any Purchaser may assign any or all of its rights under this Agreement to any Person to whom such Purchaser assigns or transfers any Securities, provided such transferee agrees in writing to be bound, with respect to the transferred Securities, by the provisions hereof that apply to the "Purchasers."

5.7 No Third-Party Beneficiaries. This Agreement is intended for the

benefit of the parties hereto and their respective successors and permitted assigns and is not for the benefit of, nor may any provision hereof be enforced by, any other Person, except as otherwise set forth in Section 4.6.

5.8 Liquidated Damages. The Company's obligations to pay any liquidated

damages or other amounts owing under the Transaction Documents is a continuing obligation of the Company and shall not terminate until all unpaid liquidated damages and other amounts have been paid notwithstanding the fact that the instrument or security pursuant to which such liquidated damages or other amounts are due and payable shall have been canceled. Such liquidated damages are not to be construed as the sole damages for remedies available to the Persons entitled to the same. The parties hereby agree that all remedies and damages are cumulative.

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5.9 Governing Law. All questions concerning the construction, validity,

enforcement and interpretation of this Agreement shall be governed by and construed and enforced in accordance with the internal laws of the State of New York, without regard to the principles of conflict of laws thereof. Each party agrees that all Proceedings concerning the interpretations, enforcement and defense of the transactions contemplated by this Agreement and any other Transaction Documents (whether brought against a party hereto or its respective affiliates, directors, officers, stockholders, employees or agents) shall be commenced exclusively in the state and federal courts sitting in the City of New York, Borough of Manhattan. Each party hereto hereby irrevocably submits to the exclusive jurisdiction of the state and federal courts sitting in the City of New York, Borough of Manhattan for the adjudication of any dispute hereunder or in connection herewith or with any transaction contemplated hereby or discussed herein (including with respect to the enforcement of the any of the Transaction Documents), and hereby irrevocably waives, and agrees not to assert in any Proceeding, any claim that it is not personally subject to the jurisdiction of any such court, or that such Proceeding has been commenced in an improper or inconvenient forum. Each party hereto hereby irrevocably waives personal service of process and consents to process being served in any such Proceeding by mailing a copy thereof via registered or certified mail or overnight delivery (with evidence of delivery) to such party at the address in effect for notices to it under this Agreement and agrees that such service shall constitute good and sufficient service of process and notice thereof. Nothing contained herein shall be deemed to limit in any way any right to serve process in any manner permitted by law. Each party hereto hereby irrevocably waives, to the fullest extent permitted by applicable law, any and all right to trial by jury in any legal proceeding arising out of or relating to this Agreement or the transactions contemplated hereby. If either party shall commence a Proceeding to enforce any provisions of a Transaction Document, then the prevailing party in such Proceeding shall be reimbursed by the other party for its reasonable attorney's fees and other actual costs and expenses incurred with the investigation, preparation and prosecution of such Proceeding.

5.10 Survival. The representations, warranties, agreements and covenants

contained herein shall survive the Closing and the delivery of the Underlying
Shares and Warrant Shares, as applicable.

5.11 Execution. This Agreement may be executed in two or more counterparts,

all of which when taken together shall be considered one and the same agreement
and shall become effective when counterparts have been signed by each party and
delivered to the other party, it being understood that all parties need not sign
the same counterpart. In the event that any signature is delivered by facsimile
transmission, such signature shall create a valid and binding obligation of the
party executing (or on whose behalf such signature is executed) with the same
force and effect as if such facsimile signature page were an original thereof.

5.12 Severability. If any provision of this Agreement is held to be invalid

or unenforceable in any respect, the validity and enforceability of the
remaining terms and provisions of this Agreement shall not in any way be
affected or impaired thereby and the parties will attempt to agree upon a valid
and enforceable provision that is a reasonable substitute therefor, and upon so
agreeing, shall incorporate such substitute provision in this Agreement.

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5.13 Rescission and Withdrawal Right. Notwithstanding anything to the

contrary contained in (and without limiting any similar provisions of) the
Transaction Documents, whenever any Purchaser exercises a right, election,
demand or option under a Transaction Document and the Company does not timely
perform its related obligations within the periods therein provided, then such
Purchaser may rescind or withdraw, in its sole discretion from time to time upon
written notice to the Company, any relevant notice, demand or election in whole
or in part without prejudice to its future actions and rights.

5.14 Replacement of Securities. If any certificate or instrument evidencing
any Securities is mutilated, lost, stolen or destroyed, the Company shall issue
or cause to be issued in exchange and substitution for and upon cancellation
thereof, or in lieu of and substitution therefor, a new certificate or
instrument, but only upon receipt of evidence reasonably satisfactory to the
Company of such loss, theft or destruction and customary and reasonable
indemnity, if requested. The applicants for a new certificate or instrument
under such circumstances shall also pay any reasonable third-party costs
associated with the issuance of such replacement Securities. If a replacement
certificate or instrument evidencing any Securities is requested due to a
mutilation thereof, the Company may require delivery of such mutilated
certificate or instrument as a condition precedent to any issuance of a
replacement.

5.1 Remedies. In addition to being entitled to exercise all rights

provided herein or granted by law, including recovery of damages, each of the
Purchasers and the Company will be entitled to specific performance under the
Transaction Documents. The parties agree that monetary damages may not be
adequate compensation for any loss incurred by reason of any breach of
obligations described in the foregoing sentence and hereby agrees to waive in
any action for specific performance of any such obligation the defense that a
remedy at law would be adequate.

5.16 Payment Set Aside. To the extent that the Company makes a payment or

payments to any Purchaser pursuant to any Transaction Document or a Purchaser
enforces or exercises its rights thereunder, and such payment or payments or the

proceeds of such enforcement or exercise or any part thereof are subsequently invalidated, declared to be fraudulent or preferential, set aside, recovered from, disgorged by or are required to be refunded, repaid or otherwise restored to the Company, a trustee, receiver or any other person under any law (including, without limitation, any bankruptcy law, state or federal law, common law or equitable cause of action), then to the extent of any such restoration the obligation or part thereof originally intended to be satisfied shall be revived and continued in full force and effect as if such payment had not been made or such enforcement or setoff had not occurred.

5.17 Independent Nature of Purchasers' Obligations and Rights. The

obligations of each Purchaser under any Transaction Document are several and not joint with the obligations of any other Purchaser, and no Purchaser shall be responsible in any way for the performance of the obligations of any other Purchaser under any Transaction Document. Nothing contained herein or in any Transaction Document, and no action taken by any Purchaser pursuant thereto, shall be deemed to constitute the Purchasers as a partnership, an association, a joint venture or any other kind of entity, or create a presumption that the Purchasers are in any way acting in concert or as a group with respect to such obligations or the transactions contemplated by the Transaction Documents. Each

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Purchaser shall be entitled to independently protect and enforce its rights, including without limitation the rights arising out of this Agreement or out of the other Transaction Documents, and it shall not be necessary for any other Purchaser to be joined as an additional party in any proceeding for such purpose.

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SIGNATURE PAGES FOLLOW]

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IN WITNESS WHEREOF, the parties hereto have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

ELECTRIC FUEL CORPORATION

By:

Name:

Title:

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SIGNATURE PAGES FOLLOW]

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IN WITNESS WHEREOF, the parties hereto have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

ZLP MASTER TECHNOLOGY FUND, LTD.

By: _____
Name:
Title:

Investment Amount: \$2,000,000

Address for Notice:
45 Broadway - 28th Floor
New York, NY 10006
Facsimile No.: ()
Attn:

With a copy to:

Bryan Cave LLP
1290 Avenue of the Americas
New York, NY 10104
Facsimile No.: (212) 541-4630 and (212) 541-1432
Attn: Eric L. Cohen, Esq.

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IN WITNESS WHEREOF, the parties hereto have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

SMITHFIELD FIDUCIARY LLC

By: _____
Name:
Title:

Investment Amount: \$1,000,000

Address for Notice:

c/o Highbridge Capital Management, LLC
9 West 57th Street, 27th Floor

New York, New York 10019
Attention: Ari J. Storch / Adam J. Chill
Facsimile: 212-751-0755
Telephone: 212-287-4720

With a copy to:

Bryan Cave LLP
1290 Avenue of the Americas
New York, NY 10104
Facsimile No.: (212) 541-4630 and
(212) 541-1432
Attn: Eric L. Cohen, Esq.

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IN WITNESS WHEREOF, the parties hereto have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

VERTICAL VENTURES INVESTMENTS, LLC

By: _____
Name: _____
Title: _____

Investment Amount: \$500,000

Address for Notice:
c/o Vertical Ventures, LLC
900 Third Avenue, 26th Floor
New York, NY 10022
Facsimile No.: (646) 274-1728
Attn: Joshua Silverman

With a copy to:

Bryan Cave LLP
1290 Avenue of the Americas
New York, NY 10104
Facsimile No.: (212) 541-4630 and
(212) 541-1432
Attn: Eric L. Cohen, Esq.

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Exhibit 4.2

NEITHER THESE SECURITIES NOR THE SECURITIES ISSUABLE UPON CONVERSION OF THESE SECURITIES HAVE BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE SECURITIES COMMISSION OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS AS EVIDENCED BY A LEGAL OPINION OF COUNSEL TO THE TRANSFEROR TO SUCH EFFECT, THE SUBSTANCE OF WHICH SHALL BE REASONABLY ACCEPTABLE TO THE COMPANY. THESE SECURITIES AND THE SECURITIES ISSUABLE UPON EXERCISE OF THESE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN SECURED BY SUCH SECURITIES.

ORIGINAL ISSUE DATE: DECEMBER31, 2002

No. []

\$[]

ELECTRIC FUEL CORPORATION
 9% SECURED CONVERTIBLE DEBENTURE DUE JUNE30, 2005

THIS DEBENTURE is one of a series of duly authorized and issued debentures of ELECTRIC FUEL CORPORATION, a corporation organized under the laws of Delaware (the "COMPANY"), designated as its 9% Secured Convertible Debentures due June 30, 2005 in the aggregate principal amount of [] Dollars (\$_____) (collectively, the "DEBENTURES").

FOR VALUE RECEIVED, the Company promises to pay to the order of [] or its registered assigns (the "HOLDER") the principal sum of [] Dollars (\$[]) and any additional sums due pursuant to the terms hereof, on June 30, 2005, or such earlier date as the Debentures are required or permitted to be repaid as provided hereunder (the "MATURITY DATE"), and to pay interest to the Holder on the principal amount of this Debenture in accordance with the provisions hereof. This Debenture is subject to the following additional provisions.

1. Definitions. In addition to the terms defined elsewhere in this

 Debenture, capitalized terms that are not otherwise defined herein shall have the meanings given to such terms in the Securities Purchase Agreement of even date herewith to which the Company and the original Holder are parties (the "PURCHASE AGREEMENT").

"AFFILIATE" means any Person that, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with a Person, as such terms are used in and construed under Rule 144 under the Securities Act.

"BANKRUPTCY EVENT" means any of the following events: (a) the Company or any subsidiary thereof commences a case or other proceeding under any bankruptcy, reorganization, arrangement, adjustment of debt, relief of debtors,

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dissolution, insolvency or Liquidation or similar law of any jurisdiction relating to the Company or any subsidiary thereof; (b) there is commenced against the Company or any subsidiary thereof any such case or proceeding that is not dismissed within 60 days after commencement; (c) the Company or any subsidiary thereof is adjudicated insolvent or bankrupt or any order of relief or other order approving any such case or proceeding is entered; (d) the Company or any subsidiary thereof suffers any appointment of any custodian or the like for it or any substantial part of its property that is not discharged or stayed within 60 days; (e) the Company or any subsidiary thereof makes a general assignment for the benefit of creditors; (f) the Company or any subsidiary thereof fails to pay, or states that it is unable to pay or is unable to pay, its debts generally as they become due; (g) the Company or any subsidiary thereof calls a meeting of its creditors with a view to arranging a composition, adjustment or restructuring of its debts; or (h) the Company or any subsidiary thereof, by any act or failure to act, expressly indicates its consent to, approval of or acquiescence in any of the foregoing or takes any corporate or other action for the purpose of effecting any of the foregoing.

"BLOOMBERG" means Bloomberg Financial L.P. (or its successor to reporting stock prices).

"BUSINESS DAY" means any day except Saturday, Sunday and any day which shall be a legal holiday or a day on which banking institutions in the State of New York are authorized or required by law or other governmental action to close.

"CLOSING DATE" shall have the meaning set forth in the Purchase Agreement.

"CLOSING PRICE" means, for any date, the price determined by the first of the following clauses that applies: (a) if the Common Stock is then listed or quoted on an Trading Market, the closing bid price per share of the Common Stock for such date (or the nearest preceding date if there is no such price on such date) on the Trading Market on which the Common Stock is then listed or quoted; (b) if the Common Stock is not then listed or quoted on an Trading Market and if prices for the Common Stock are then quoted on the OTC Bulletin Board, the closing bid price per share of the Common Stock for such date (or the nearest preceding date if there is no such price on such date) on the OTC Bulletin Board; (c) if the Common Stock is not then listed or quoted on an Trading Market or the OTC Bulletin Board and if prices for the Common Stock are then reported in the "Pink Sheets" published by the Pink Sheets LLC (formerly the National Quotation Bureau Incorporated) (or a similar organization or agency succeeding to its functions of reporting prices), the most recent bid price per share of the Common Stock so reported; or (d) in all other cases, the fair market value of a share of Common Stock as determined by an independent appraiser selected in good faith by the Holder.

"COMMISSION" means the Securities and Exchange Commission.

"COMMON STOCK" means the Company's Common Stock, \$.01 par value per share, and stock of any other class into which such shares may be reclassified.

"COMMON SHARE EQUIVALENTS" means any securities of the Company or any Subsidiary (as defined in the Purchase Agreement) which entitle the holder thereof to acquire Common Stock at any time, including without limitation, any debt, preferred stock, rights, options, warrants or other instrument that is at

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any time convertible into or exchangeable for, or otherwise entitles the holder

thereof to receive, Common Stock or other securities that entitle the holder to receive, directly or indirectly, Common Stock.

"COMPANY REDEMPTION PRICE" means the sum of (i) the outstanding principal amount of this Debenture plus (ii) all other amounts, interest and liquidated damages due in respect of this Debentures.

"CONVERSION DATE" is the date specified in a Conversion Notice to effect conversions of Debentures under Section 5(a)(i), which date may not be prior to the date the Holder delivers such Conversion Notice. If no Conversion Date is specified in a Conversion Notice, then the Conversion Date for such notice shall be the date that such notice is deemed delivered hereunder.

"CONVERSION PRICE" means \$.75 (subject to adjustment in accordance with Section 5(d)).

"DISTRIBUTION" means, with respect to any Person, the declaration or payment of any dividends by such Person, or the purchase, redemption, retirement or other acquisition for value of any of its capital stock or other equity now or hereafter outstanding, or the making of any distribution of assets to its stockholders as such whether in cash, assets or in obligations of such Person, or the allocation or other setting apart of any sum for the payment of any dividend or distribution on, or for the purchase, redemption, retirement or other acquisition of any shares of its capital stock, or the making of any other distribution by reduction of capital or otherwise in respect of any shares of its capital stock.

"INTEREST PAYMENT DATE" means each of March 31, June 30, September 30 and December 31, except if such date is not a Trading Day, in which case such Interest Payment Date shall be the next succeeding Trading Day.

"EFFECTIVE DATE" means the date that the initial Registration Statement is first declared effective by the Securities and Exchange Commission.

"EXCHANGE ACT" means the Securities Exchange Act of 1934, as amended.

"EQUITY CONDITIONS" means, with respect to a specified issuance of Common Stock, that each of the following conditions is satisfied: (i) the number of authorized but unissued and otherwise unreserved shares of Common Stock is sufficient for such issuance; (ii) such shares of Common Stock are registered for resale by the Holder pursuant to an effective registration statement, and the prospectus thereunder is available for use by the Holder to sell such shares, or all such shares may be sold by the Holder without volume restrictions pursuant to Rule 144(k) under the Securities Act; (iii) the Common Stock is listed or quoted (and is not suspended from trading) on a Trading Market and such shares of Common Stock are approved for listing on such Trading Market upon issuance; (iv) such issuance would be permitted in full without violating the rules or regulations of the Trading Market on which such shares are listed or quoted; (v) no Bankruptcy Event has occurred; (vii) the Company is not in default with respect to any obligation hereunder or under any other Transaction Document; or (ix) no Event of Default nor any event that with the passage of time and without being cured would constitute an Event of Default which has occurred and not been cured.

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"EVENT OF DEFAULT" means the occurrence of any one or more of the following events (whatever the reason and whether it shall be voluntary or involuntary or effected by operation of law or pursuant to any judgment, decree or order of any court, or any order, rule or regulation of any administrative or governmental body):

(i) any default in the payment of principal or liquidated damages in respect of any Debentures, as and when the same becomes due and payable (whether by acceleration or otherwise) or any default in the payment of interest in respect of any Debentures, within five Trading Days of when the same becomes due and payable;

(ii) any default in the payment of the Additional Payment (as hereinafter defined) as and when the same becomes due and payable, within five Trading Days of when the same becomes due and payable;

(iii) the Company or any Subsidiary defaults in any of its obligations under any other debenture or any mortgage, credit agreement or other facility, indenture agreement, factoring agreement or other instrument under which there may be issued, or by which there may be secured or evidenced, any Indebtedness, whether such Indebtedness now exists or is hereafter created, and such default results in such Indebtedness becoming or being declared due and payable prior to the date on which it would otherwise become due and payable;

(iv) a Bankruptcy Event;

(v) the Company shall fail for any reason to deliver certificates representing Underlying Shares issuable upon a conversion hereunder that comply with the provisions hereof prior to the fifth Trading Day after the Conversion Date or the Company shall provide notice to any Holder, including by way of public announcement, at any time, of its intention not to comply with requests for conversion of Debentures in accordance with the terms hereof;

(vi) the Company shall fail for any reason to pay in full the amount of cash due pursuant to a Buy-In within seven days after notice therefor is delivered hereunder or shall fail to pay any liquidated damages due pursuant to the Transaction Documents within seven days of the date of the request for such payment;

(vii) the Company shall fail to have available a sufficient number of authorized and unreserved shares of Common Stock to issue to such Holder upon a conversion hereunder;

(viii) a Fundamental Transaction with respect to the Company or its subsidiaries;

(ix) the Registration Statement shall not have been declared effective by the Commission on or prior to the 90th day after the Original Issue Date;

(x) during the Effectiveness Period (as defined in the Registration Rights Agreement), the effectiveness of the Registration Statement lapses for any reason or the Holder shall not be permitted to resell Registrable Securities (as defined in the Registration Rights Agreement) under the Registration Statement, in either case, for more than five consecutive Trading Days or an aggregate of eight Trading Days (which need not be consecutive Trading Days);

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(xi) an Event (as defined in the Registration Rights Agreement) shall not have been cured to the satisfaction of the Holder prior to the expiration of ten days from the Event Date (as defined in the Registration Rights Agreement) relating thereto (other than an Event resulting from a failure of a Registration Statement to be declared effective by the Commission on or prior to the 90th day after the Original Issue Date, which shall be covered by clause (viii) above);

(xii) the Company defaults in the timely performance of any other obligation under the Transaction Documents (including, without limitation, any of the Security Agreements) and such default continues uncured for a period of

five Trading Days after the date on which written notice of such default is first given to the Company by the Holder (it being understood that no prior notice need be given in the case of a default that cannot reasonably be cured within five Trading Days); and

(xiii) the Company or any Subsidiary takes (or agrees to take) any Restricted Action in violation of this Debenture.

"FILING DATE" shall have the meaning set forth in the Registration Rights Agreement.

"FUNDAMENTAL TRANSACTION" means any (i) merger or consolidation of the Company with or into another Person, (ii) any sale of more than one-half of the assets of the Company (on an as valued basis) in one or a series of related transactions, (iii) any tender offer or exchange offer (whether by the Company or another Person) pursuant to which holders of Common Stock are permitted to tender or exchange their shares for other securities, cash or property, or (iv) any reclassification of the Common Stock or any compulsory share exchange pursuant to which the Common Stock is effectively converted into or exchanged for other securities, cash or property.

"INDEBTEDNESS" shall mean the principal amount of, premium, if any, profit participation, if any, and accrued and unpaid interest on and all other amounts and costs payable in respect of (a) indebtedness for money borrowed from others; (b) indebtedness guaranteed, directly or indirectly, in any manner, or in effect guaranteed, directly or indirectly, in any manner through an agreement, contingent or otherwise, to supply funds to, or in any other manner invest in the debtor, or to purchase indebtedness, or to purchase and pay for property if not delivered or pay for services if not performed, primarily for the purpose of enabling the debtor to make payment of the indebtedness or to assure the owners of the indebtedness against loss; (c) all indebtedness secured by any mortgage, lien, pledge, charge or other encumbrance upon property owned by the Company; (d) all indebtedness of such person created or arising under any conditional sale, lease (intended primarily as a financing device) or other title retention or security agreement with respect to property acquired by the Company even though the rights and remedies of the seller, lessor or lender under such agreement or lease in the event of a default may be limited to repossession or sale of such property; (e); and (f) renewals, extensions and refundings of any such indebtedness.

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"INTEREST SHARES" means the shares of Common Stock issued or issuable in payment of accrued interest under Section 2.

"LIEN" means any lien (statutory or otherwise), security interest, mortgage, deed of trust, priority, pledge, charge, conditional sale, title retention agreement, financing lease or other encumbrance or similar right of others, or any agreement to give any of the foregoing.

"LIQUIDATION" means for any Person, any liquidation, dissolution or winding-up of such Person, whether voluntary or involuntary, by operation or law or otherwise.

"MANDATORY PREPAYMENT AMOUNT" for any Debentures shall equal the sum of: (i) the greater of (A) the principal amount of Debentures to be prepaid and, if applicable, the Reinstated Principal (to the extent the Holder returns the Underlying Shares subject to such Reinstated Principal), plus all accrued and unpaid interest thereon, and (B) the principal amount of Debentures to be prepaid and, if applicable, the Reinstated Principal (to the extent the Holder returns the Underlying Shares subject to such Reinstated Principal), plus all accrued and unpaid interest thereon, divided by the Conversion Price on the Trading Day immediately preceding (x) the date of the Event of Default or (y)

the date the Mandatory Prepayment Amount is paid in full, whichever is less, multiplied by the Closing Price on (x) the date of the Event of Default or (y) the date the Mandatory Prepayment Amount is paid in full, whichever is greater, and (ii) all other amounts, costs, expenses and liquidated damages due in respect of such Debentures.

"ORIGINAL ISSUE DATE" means the date of the first issuance of any Debentures regardless of the number of transfers of any particular Debenture and regardless of the number of certificates which may be issued to evidence such Debentures.

"PERSON" means an individual or corporation, partnership, trust, incorporated or unincorporated association, joint venture, limited liability company, joint stock company, government (or an agency or subdivision thereof) or other entity of any kind.

"PROCEEDING" means an action, claim, suit, investigation or proceeding (including, without limitation, an investigation or partial proceeding, such as a deposition), whether commenced or threatened concerning the interpretation, enforcement or defense of any transaction contemplated by any Transaction Document (whether brought against a party hereto or such parties affiliates, directors, officers, employees or agents).

"PROPERTY" means any interest in any kind of property or asset, whether real, personal or mixed, and whether tangible or intangible, of the Company or any of its subsidiaries, now or hereinafter acquired

"REGISTRATION RIGHTS AGREEMENT" means the Registration Rights Agreement, dated as of the Original Issuance Date, to which the Company and the original Holders are parties, as amended, modified or supplemented from time to time in accordance with its terms.

"REGISTRATION STATEMENT" means a registration statement meeting the requirements of the Registration Rights Agreement and covering the resale of, among other things, all Underlying Shares by the Holders, who shall be named as "selling stockholders" thereunder.

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"REINSTATED PRINCIPAL" means the principal amount of Debentures converted during the ten Trading Days preceding the delivery of an Event of Default Notice, for which the Company issued or was obligated to issue Underlying Shares to the Holder.

"RESTRICTED ACTIONS" means the taking by Company or any of its subsidiaries of any of the following actions"

(i) create, incur, assume or suffer to exist any Indebtedness, other than Indebtedness reflected in the Company's most recent quarterly financial statement that has been filed with the Commission prior to the Original Issuance Date, or Indebtedness in the ordinary course of business consistent with past practices; provided, however, that the Company may incur indebtedness to borrow funds in an amount not to exceed \$1,000,000 to be used solely in connection with the operation of the zinc air battery business, which amount will be an unsecured obligation of the Company; provided, further, that such lenders shall have entered a subordination agreement with the holders of the Debentures in a form agreed to by the holders of the Debentures;

(ii) create, incur, assume or suffer to exist any guaranty, provided, that the Company may suffer to exist any existing guaranties for obligations of Subsidiaries that it had entered into in the ordinary course of business consistent with past practice;

(iii) create, incur, assume or suffer to exist any Lien, upon or with respect to any interest in Property, except for Liens disclosed in the Purchase Agreement or for Liens pursuant to the Debenture or for Liens incurred in connection with the settlement with Yehuda Harats regarding assets of Electric Fuel (E.F.L.) Ltd.;

(iii) create, incur, assume or suffer to exist any obligation as lessee for the rental or hire of any Property, except leases existing on the Original Issuance Date, and any extensions, supplements or renewals thereof;

(iv) make any loan or advance to any Person or any purchase or other acquisition of any capital stock, assets, obligations or other securities of any Person, or any capital contribution to, investment in, or other acquisition of any interest in, any Person;

(v) make any Distribution, except that any subsidiary may make Distributions to the Company;

(vi) make any capital expenditures, in any single or a series of related transactions, during any year, exceeding \$75,000;

(vii) sell, lease, assign, transfer or otherwise dispose of any of its now owned or hereafter acquired Property (including, without limitation, shares of stock and Indebtedness, receivables and leasehold interests), except in the ordinary course of business consistent with past practices;

(viii) sell, lease, assign or otherwise dispose of any Property to any Affiliate; (a) merge into or consolidate with or purchase or acquire Property

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from any Affiliate; or (b) enter into any other transaction directly or indirectly with or for the benefit of any Affiliate (including, without limitation, guaranties and assumption of obligations of any Affiliate); provided that; any Affiliate who is an individual may serve as a director, officer or employee of the Company or any subsidiary thereof and receive reasonable compensation for his or her services in such capacity;

(ix) merge or consolidate with, or sell, assign, lease or otherwise dispose of (whether in one transaction or in a series of related transactions) all or substantially all of its assets (whether now owned or hereafter acquired) to, any Person, or acquire all or substantially all of the assets or the business of any Person (or enter into any agreement to do any of the foregoing);

(x) enter into any agreement with respect to any of the foregoing provisions (i) through (ix).

"SECURITIES ACT" means the Securities Act of 1933, as amended.

"SECURITY AGREEMENTS" means (i) the Security Agreement, dated as of the Original Issuance Date, by and among the Company, the subsidiaries of the Company party thereto and the holders of the Debentures and (ii) the Intellectual Property Security Agreement, dated as of the Original Issuance Date, by and among the Company, the subsidiaries of the Company party thereto and the holders of the Debentures.

"TRADING DAY" means (i) a day on which the Common Stock is traded on an Trading Market, or (ii) if the Common Stock is not listed on an Trading Market, a day on which the Common Stock is traded in the over the counter market, as reported by the OTC Bulletin Board, or (iii) if the Common Stock is not quoted on the OTC Bulletin Board, a day on which the Common Stock is quoted in the over the counter market as reported by the National Quotation Bureau Incorporated (or

any similar organization or agency succeeding its functions of reporting prices); provided, that in the event that the Common Stock is not listed or quoted as set forth in (i), (ii) and (iii) hereof, then Trading Day shall mean a business day.

"TRADING MARKET" means whichever of the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market or the Nasdaq SmallCap Market on which the Common Stock is then listed or quoted on the date in question.

"TRANSACTION DOCUMENTS" shall have the meaning set forth in the Purchase Agreement.

"UNDERLYING SHARES" means, collectively, the Common Stock issuable upon conversion of Debentures and the Interest Shares in accordance with the terms hereof.

"VWAP" means, with respect to any date of determination, the daily volume weighted average price (as reported by Bloomberg using the VAP function) of the Common Stock on such date of determination, or if there is no such price on such date of determination, then the daily volume weighted average price on the date nearest preceding such date.

"WARRANTS" shall have the meaning set forth in the Purchase Agreement.

2. Interest.

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(a) The Company shall pay interest to the Holder on the aggregate unconverted and then outstanding principal amount of this Debenture (including any interest added to such principal in accordance with this Section 2) at the rate of 9% per annum, payable in arrears on each Interest Payment Date and on the Maturity Date; provided, that interest for the first nine months following the Original Issuance Date shall be paid on the Original Issuance Date by delivering to the Holder on such date such number of shares of Common Stock (the "INTEREST SHARES") equal to the quotient obtained by dividing the amount of such interest by the arithmetic average of the VWAP for each of the five (5) Trading Days immediately preceding (but not including) the Original Issuance Date. Interest shall be calculated on the basis of a 360-day year and shall accrue daily commencing on the Original Issue Date (regardless of the number of transfers of the Debentures).

(b) Except as provided in Section 2(a), the Company shall pay interest under this Debenture in cash. If the Company fails for any reason to pay interest on the Interest Payment Date, the Holder may (but shall not be required to) treat such interest as if it had been added to the principal amount of this Debenture as of such Interest Payment Date.

(c) On each of the first three Interest Payment Dates, the Company shall deliver to the Holder an amount (the "ADDITIONAL PAYMENT"), in cash, equal to the product (if a positive number) of (x) the difference, if any, between (i) the arithmetic average of the VWAP for each of the five (5) Trading Days immediately preceding (but not including) the Original Issuance Date and (ii) the arithmetic average of the VWAP for each of the five (5) Trading Days immediately preceding (but not including) the applicable Interest Payment Date times (y) the product of (i) .0225 times (ii) the outstanding principal amount of this Debenture.

(d) If on any of the first three Interest Payment Dates, the Equity Conditions are not satisfied with respect to the Interest Shares, then the

Holder, at its sole option, shall have the right to require the Company to repurchase from the Holder a number of Interest Shares equal to 1/3 of the Interest Shares delivered by the Company to such Holder at Closing for a repurchase price equal to the cash amount of the interest due and payable on such Interest Payment Date. The Holder may exercise this right by delivering a put notice to the Company not more than 1 Trading Day following the Interest Payment Date. The Holder shall not be obligated to deliver the Interest Shares subject to the put notice at issue until such time as payment of the put price shall have been received by such Holder.

(e) Any interest to be paid in cash hereunder that is not paid on the Interest Payment Date and not added to the principal amount of the Debenture shall continue to accrue and shall entail a late fee, which must be paid in cash, at the rate of 12% per annum or the lesser rate permitted by applicable law (such fees to accrue daily, from the date such interest is due hereunder through and including the date of payment).

3. Registration of Debentures. The Company shall register the Debentures

upon records to be maintained by the Company for that purpose (the "DEBENTURE REGISTER") in the name of each record holder thereof from time to time. The Company may deem and treat the registered Holder of this Debenture as the absolute owner hereof for the purpose of any conversion hereof or any payment of interest hereon, and for all other purposes, absent actual notice to the contrary.

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4. Registration of Transfers and Exchanges. The Company shall register the

transfer of any portion of this Debenture in the Debenture Register upon surrender of this Debenture to the Company at its address for notice set forth herein. Upon any such registration or transfer, a new debenture, in substantially the form of this Debenture (any such new debenture, a "NEW DEBENTURE"), evidencing the portion of this Debenture so transferred shall be issued to the transferee and a New Debenture evidencing the remaining portion of this Debenture not so transferred, if any, shall be issued to the transferring Holder. The acceptance of the New Debenture by the transferee thereof shall be deemed the acceptance by such transferee of all of the rights and obligations of a holder of a Debenture. This Debenture is exchangeable for an equal aggregate principal amount of Debentures of different authorized denominations, as requested by the Holder surrendering the same. No service charge or other fee will be imposed in connection with any such registration of transfer or exchange. Transfers of this Debenture and the Underlying Shares are governed by Section 4.1 of the Purchase Agreement.

5. Conversion.

(a) At the Option of the Holder. All or any portion of the principal

amount of this Debenture then outstanding (together with all accrued but unpaid interest thereon) shall be convertible into Common Stock (subject to the limitations set forth in Section 5(b)), at the option of the Holder, at any time and from time to time from and after the Original Issue Date. Holders shall effect conversions under this Section 5(a)(i) by delivering the Company with a written notice in the form attached hereto as Exhibit A (a "CONVERSION

NOTICE") together with a schedule in the form of Schedule 1 attached hereto (the

"CONVERSION SCHEDULE"). The number of Underlying Shares issuable upon any conversion hereunder shall (subject to the limitations of Section 5(b)) equal the outstanding principal amount of this Debenture (plus all accrued but unpaid

interest thereon)to be converted divided by the Conversion Price.

(b) Certain Conversion Restrictions.

(i) Notwithstanding anything to the contrary contained herein, the number of shares of Common Stock that may be acquired by a Holder upon any conversion of Debentures (or otherwise in respect hereof) shall be limited to the extent necessary to insure that, following such conversion (or other issuance), the total number of shares of Common Stock then beneficially owned by such Holder and its affiliates and any other Persons whose beneficial ownership of shares of Common Stock would be aggregated with such Holder's for purposes of Section 13(d) of the Exchange Act, does not exceed 4.999% of the total number of issued and outstanding shares of Common Stock (including for such purpose the shares of Common Stock issuable upon such conversion). For such purposes, beneficial ownership shall be determined in accordance with Section 13(d) of the Exchange Act and the rules and regulations promulgated thereunder. Each delivery of a Conversion Notice hereunder will constitute a representation by the applicable Holder that it has evaluated the limitation set forth in this paragraph and determined that issuance of the full number of Underlying Shares issuable in respect of such Conversion Notice does not violate the restriction contained in this paragraph. By written notice to the Company, the Holder may waive the provisions of this Section but (i) any such waiver will not be effective until the 61st day after such notice is delivered to the Company, and (ii) any such waiver will apply only to the Holder and not to any other holder of Debentures. This provision shall not restrict the number of shares of Common Stock which a Holder may receive or beneficially

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own in order to determine the amount of securities or other consideration that such Holder may receive in the event of a merger, sale or other business combination or reclassification involving the Company as contemplated herein.

(ii) Notwithstanding anything to the contrary contained herein, the number of shares of Common Stock that may be acquired by a Holder upon any conversion of Debentures (or otherwise in respect hereof) shall be limited to the extent necessary to insure that, following such conversion (or other issuance), the total number of shares of Common Stock then beneficially owned by such Holder and its affiliates and any other Persons whose beneficial ownership of shares of Common Stock would be aggregated with such Holder's for purposes of Section 13(d) of the Exchange Act, does not exceed 9.999% of the total number of issued and outstanding shares of Common Stock (including for such purpose the shares of Common Stock issuable upon such conversion). For such purposes, beneficial ownership shall be determined in accordance with Section 13(d) of the Exchange Act and the rules and regulations promulgated thereunder. Each delivery of a Conversion Notice hereunder will constitute a representation by the applicable Holder that it has evaluated the limitation set forth in this paragraph and determined that issuance of the full number of Underlying Shares issuable in respect of such Conversion Notice does not violate the restriction contained in this paragraph. This provision shall not restrict the number of shares of Common Stock which a Holder may receive or beneficially own in order to determine the amount of securities or other consideration that such Holder may receive in the event of a merger, sale or other business combination or reclassification involving the Company as contemplated herein.

(c) Mechanics of Conversion.

(i) By the third Trading Day after each Conversion Date, the Company shall issue or cause to be issued and cause to be delivered to or upon the written order of the Holder and in such name or names as the Holder may designate a certificate for the Underlying Shares issuable upon such conversion which, unless required by the Purchase Agreement, shall be free of all restrictive legends. The Holder, or any Person so designated by the Holder to receive Underlying Shares, shall be deemed to have become the holder of record of such Underlying Shares as of the Conversion Date. If the Company's transfer agent is eligible to participate in the Depository Trust Corporation DWAC system and no legends are required to be included on the certificates representing Underlying Shares pursuant to the Purchase Agreement, the Company shall, upon request of the Holder, use its best efforts to deliver Underlying Shares hereunder electronically through the Depository Trust Corporation or another established clearing corporation performing similar functions.

(ii) To effect conversions hereunder, the Holder shall not be required to physically surrender this Debenture unless the aggregate principal amount represented by such Debenture is being converted, in which event, the Holder shall deliver such Debenture promptly to the Company (it being understood that such delivery is not a condition precedent to the Company's obligations to deliver Underlying Shares upon such conversion). Conversions hereunder shall have the effect of lowering the outstanding principal amount represented by such Debenture in an amount equal to the applicable conversion, which shall be evidenced by entries set forth in the Conversion Schedule attached as Schedule I, which will be maintained by the Company

and the Holder.

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(iii) The Company's obligations to issue and deliver Underlying Shares upon conversion of this Debenture in accordance with the terms hereof are absolute and unconditional, irrespective of any action or inaction by the Holder to enforce the same, any waiver or consent with respect to any provision hereof, the recovery of any judgment against any Person or any action to enforce the same, or any setoff, counterclaim, recoupment, limitation or termination, or any breach or alleged breach by the Holder or any other Person of any obligation to the Company or any violation or alleged violation of law by the Holder or any other Person, and irrespective of any other circumstance which might otherwise limit such obligation of the Company to the Holder in connection with the issuance of such Underlying Shares.

(iv) If by the third Trading Day after a Conversion Date the Company fails to deliver to the Holder such Underlying Shares in such amounts and in the manner required pursuant to Section 5(a), then the Holder will have the right to rescind such conversion.

(v) If by the third Trading Day after a Conversion Date the Company fails to deliver to the Holder such Underlying Shares in such amounts and in the manner required pursuant to this Section 5(c), and if after such third Trading Day the Holder purchases (in an open market transaction or otherwise) shares of Common Stock to deliver in satisfaction of a sale by such Holder of the Underlying Shares which the Holder anticipated receiving upon such conversion (a "BUY-IN"), then the Company shall: (A) pay in cash to the Holder (in addition to any remedies available to or elected by the Holder) the amount by which (x) the Holder's total purchase price (including brokerage commissions, if any) for the shares of Common Stock so purchased exceeds (y) the amount obtained by multiplying (1) the aggregate number of Underlying Shares that the Company was required to deliver to the

Holder in connection with the conversion at issue by (2) the Closing Price at the time of the obligation giving rise to such purchase obligation and (B) at the option of the Holder, either reinstate the principal amount of Debentures and equivalent number of Underlying Shares for which such conversion was not timely honored or deliver to the Holder the number of shares of Common Stock that would have been issued had the Company timely complied with its conversion and delivery obligations hereunder. For example, if the Holder purchases shares of Common Stock having a total purchase price of \$11,000 to cover a Buy-In with respect to an attempted conversion of Debentures with a market price on the date of conversion totaling \$10,000, under clause (A) of the immediately preceding sentence, the Company shall be required to pay the Holder \$1,000. The Holder shall provide the Company written notice indicating the amounts payable to the Holder in respect of the Buy-In.

(d) Adjustments to Conversion Price. The Conversion Price in effect on any

Conversion Date shall be subject to adjustments in accordance with this Section 5(d):

(i) Stock Dividends and Splits. If the Company, at any time

while any Debentures are outstanding, (i) pays a stock dividend on its shares of Common Stock or otherwise makes a distribution on any class of capital stock that is payable in shares of Common Stock, (ii) subdivides outstanding shares of Common Stock into a larger number of shares, or (iii) combines outstanding shares of Common Stock into a smaller number of shares, then in each such case the Conversion Price shall be multiplied by a fraction of which the numerator shall be the number of shares of Common Stock outstanding immediately before such event and of which the denominator shall be the number of shares of Common Stock outstanding immediately after such event. Any adjustment made pursuant to clause (i) of this paragraph shall become effective immediately after the record date for the determination of stockholders entitled to receive such dividend or distribution, and any adjustment pursuant to clause (ii) or (iii) of this paragraph shall become effective immediately after the effective date of such subdivision or combination.

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(ii) Additional Distributions. If the Company, at any time while any

Debentures are outstanding, shall distribute to all holders of shares of Common Stock (and not to Holders) evidences of its indebtedness or assets or rights or warrants to subscribe for or purchase any security, then in each such case the Conversion Price at which the principal amount of Debentures shall thereafter be convertible shall be determined by multiplying the Conversion Price in effect immediately prior to the record date fixed for determination of stockholders entitled to receive such distribution by a fraction of which the denominator shall be the Closing Price determined as of the record date mentioned above, and of which the numerator shall be such Closing Price on such record date less the then fair market value at such record date of the portion of such assets or evidence of indebtedness so distributed applicable to one outstanding share of Common Stock as determined by the Board of Directors in good faith. In either case the adjustments shall be described in a statement provided to the Holders of the portion of assets or evidences of indebtedness so distributed or such subscription rights applicable to one share of Common Stock. Such adjustment shall be made whenever any such distribution is made and shall become effective immediately after the record date mentioned above.

(iii) Calculations. All calculations under this Section 5 shall be

made to the nearest cent or the nearest 1/100th of a share, as the case may be. The number of shares of Common Stock outstanding at any given time shall not include shares owned or held by or for the account of the Company, and the disposition of any such shares shall be considered an issue or sale of Common Stock.

(iv) Notice of Adjustments. Whenever the Conversion Price is adjusted

pursuant to the terms hereof the Company shall promptly mail to each Holder, a notice setting forth the Conversion Price after such adjustment and setting forth a brief statement of the facts requiring such adjustment.

(e) Certain Fundamental Transactions. In case of any Fundamental

Transaction, a Holder shall have the right to do any of the following: (1) convert its Debentures into the shares of stock and other securities, cash and property receivable upon or deemed to be held by holders of shares of Common Stock following such Fundamental Transaction and such Holder shall be entitled upon such Fundamental Transaction to receive such amount of securities, cash and property as the shares of Common Stock into which such Debentures could have been converted immediately prior to such Fundamental Transaction would have been entitled, or (2)(x) require the surviving entity to issue debentures in such principal amount equal to the principal amount of the Debentures held by such Holder prior to such Fundamental Transaction, plus all other amounts owing thereon, which newly issued debentures shall have identical terms to the terms of the Debentures and shall be entitled to all of the rights and privileges of a Holder set forth herein and the agreements pursuant to which the prepayment was issued, and (y) simultaneously with the issuance of such convertible debentures shall have the right to convert such shares only into shares of stock and other securities, cash and property receivable upon or deemed to be held by holders of shares of Common Stock following such Fundamental Transaction (the conversion price applicable for the newly issued convertible debentures shall be based upon the amount of securities, cash and property that each Common Share would receive in such Fundamental Transaction and the Conversion Price stated herein) or (3) at the Holder's option and request, any successor to the Company or surviving entity in such Fundamental Transaction shall either pay to the Holder the greater of (A) the outstanding principal amount of the Debentures held by such Holder plus all accrued and unpaid interest thereon, and (B) the principal amount of the Debenture held by such Holder, plus all accrued and unpaid interest thereon, divided by the Conversion Price on the Trading Day immediately preceding (x) the date of prior to such Fundamental Transaction or (y) the date the amount set forth in this section is paid in full, whichever is less, multiplied by the Closing Price on (x) the date of the Fundamental Transaction

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or (y) the date the amount set forth in this section is paid in full, whichever is greater. Any Fundamental Transaction shall include such terms so as continue to give the Holders the right to receive the securities, cash and property set forth in this Section upon any conversion or redemption following such event. This provision shall similarly apply to successive such Fundamental Transactions. The rights set forth herein shall not alter the rights of a Holder set forth elsewhere in this Debenture; provided, that a Holder may only exercise the rights set forth herein with respect to a single event giving rise to such rights.

(f) Reclassifications; Share Exchanges. In case of any reclassification of

the shares of Common Stock, or any compulsory share exchange pursuant to which the shares of Common Stock are converted into other securities, cash or

property, the Holders of the Debentures then outstanding shall have the right thereafter to convert such shares only into the shares of stock and other securities, cash and property receivable upon or deemed to be held by holders of shares of Common Stock following such reclassification or share exchange, and the Holders shall be entitled upon such event to receive such amount of securities, cash or property as a holder of the number of shares of Common Stock of the Company into which such shares of Debentures could have been converted immediately prior to such reclassification or share exchange would have been entitled. This provision shall similarly apply to successive reclassifications or share exchanges.

(g) Notice of Corporate Events. If: (a) the Company shall declare a

dividend (or any other distribution) on the Common Stock, (b) the Company shall declare a special nonrecurring cash dividend on or a redemption of the Common Stock, (c) the Company shall authorize the granting to all holders of Common Stock rights or warrants to subscribe for or purchase any shares of capital stock of any class or of any rights, (d) the approval of any stockholders of the Company shall be required in connection with any Fundamental Transaction, or (e) the Company shall authorize the voluntary or involuntary dissolution, liquidation or winding up of the affairs of the Company; then the Company shall file a press release or Current Report on Form 8-K to disclose such occurrence and notify the Holders at their last addresses as they shall appear upon the stock books of the Company, at least 20 calendar days prior to the applicable record or effective date hereinafter specified, a notice stating (x) the date on which a record is to be taken for the purpose of such dividend, distribution, redemption, rights or warrants, or if a record is not to be taken, the date as of which the holders of Common Stock of record to be entitled to such dividend, distributions, redemption, rights or warrants are to be determined or (y) the date on which any such Fundamental Transaction is expected to become effective

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or close, and the date as of which it is expected that holders of Common Stock of record shall be entitled to exchange their Common Stock for securities, cash or other property deliverable upon any such Fundamental Transaction. Holders are entitled to convert the outstanding principal amount of the Debentures during the 10-day period commencing the date of such notice to the effective date of the event triggering such notice.

(h) Reservation of Common Stock. The Company covenants that it will at all

times reserve and keep available out of its authorized and unissued shares of Common Stock solely for the purpose of issuance upon conversion of Debentures, each as herein provided, free from preemptive rights or any other actual contingent purchase rights of persons other than the Holders, not less than such number of shares of Common Stock as shall be issuable upon the conversion of all outstanding principal amount of Debentures. The Company covenants that all shares of Common Stock that shall be so issuable shall, upon issue, be duly and validly authorized and issued and fully paid and nonassessable.

(i) Fractional Shares. Upon a conversion hereunder the Company shall not be

required to issue stock certificates representing fractions of shares of Common Stock, but may if otherwise permitted, make a cash payment in respect of any final fraction of a share based on the Closing Price on the applicable Conversion Date. If any fraction of an Underlying Share would, except for the provisions of this Section, be issuable upon a conversion hereunder, the Company shall pay an amount in cash equal to the Conversion Price multiplied by such fraction.

(j) Stamp Taxes. The issuance of certificates for Common Stock on

conversion of principal amount of this Debenture shall be made without charge to the Holders thereof for any documentary stamp or similar taxes that may be payable in respect of the issue or delivery of such certificate, provided that the Company shall not be required to pay any tax that may be payable in respect of any transfer involved in the issuance and delivery of any such certificate upon conversion in a name other than that of the Holder of such Debentures so converted.

(k) Notices. Any and all notices or other communications or deliveries to

be provided by the Holders, including, without limitation, any Holder Conversion Notice, shall be in writing and delivered personally, by facsimile or sent by a nationally recognized overnight courier service, addressed to the attention of the Chief Financial Officer of the Company addressed to Electric Fuel Corporation, 632 Broadway, Suite 301, New York, NY 10012, fax: (212) 529-5800, attention Chief Financial Officer and General Counsel, with a copy to Electric Fuel (E.F.L.) Ltd., Western Industrial Zone, Beit Shemesh 99000, Israel, Facsimile No.: 011-972-2-990-6688, Attn.: Chief Financial Officer and General Counsel, or to such other address or facsimile number as shall be specified in writing by the Company for such purpose. Any and all notices or other communications or deliveries to be provided by the Company hereunder shall be in writing and delivered personally, by facsimile or sent by a nationally recognized overnight courier service, addressed to each Holder at the facsimile telephone number or address of such Holder appearing on the books of the Company, or if no such facsimile telephone number or address appears, at the principal place of business of the Holder. Any notice or other communication or deliveries hereunder shall be deemed given and effective on the earliest of (i) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile telephone number specified in this Section prior to 6:30 p.m. (New York City time)(with confirmation of transmission), (ii) the date after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile telephone number specified in this Section later than 6:30 p.m. (New York City time) on any date and earlier than 11:59 p.m. (New York City time) on such date (with confirmation of transmission), (iii) upon receipt, if sent by a nationally recognized overnight courier service, or (iv) upon actual receipt by the party to whom such notice is required to be given.

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6. Prepayment.

(a) Upon Event of Default. Upon the occurrence of a Event of Default, each

Holder shall (in addition to all other rights it may have hereunder or under applicable law), have the right, exercisable at the sole option of such Holder, and by delivery of a written notice to the Company to require the Company (an "EVENT OF DEFAULT NOTICE") to prepay all or a portion of the Debentures then held by such Holder and, at the option of the Holder, all or a portion of the Reinstated Principal, for an amount, in cash, equal to the Mandatory Prepayment Amount. The Mandatory Prepayment Amount shall be due and payable within five Trading Days of the date of the Event of Default Notice. For purposes of this Section, principal amount of Debentures shall remain outstanding until such date as the Holder shall have received Underlying Shares upon a conversion (or attempted conversion) thereof that meets the requirements hereof. Notwithstanding anything herein to the contrary, upon the occurrence of a Bankruptcy Event, all outstanding principal and accrued but unpaid interest on this Debenture shall immediately become due and payable in full in cash, without any further action by the Holder, and the Company shall immediately be obligated to pay the Mandatory Prepayment Amount pursuant to this paragraph as if the Holder had delivered a Event of Default Notice immediately prior to the occurrence of any such Event of Default. The Holder need not provide and the Company hereby waives any presentment, demand, protest or other notice of any

kind, and the Holder may immediately and without expiration of any grace period enforce any and all of its rights and remedies hereunder and all other remedies available to it under applicable law. Such declaration may be rescinded and annulled by Holder at any time prior to payment hereunder. No such rescission or annulment shall affect any subsequent Event of Default or impair any right consequent thereon.

(b) At Company's Option. At any time after the Effective Date, the Company

may deliver a notice to the Holders (an "OPTIONAL PREPAYMENT NOTICE" and the date such notice is received by the Holders, the "OPTIONAL PREPAYMENT NOTICE DATE") of its irrevocable election to prepay all, or any portion, of the then aggregate amount of outstanding Debentures, for an amount, in cash, equal to the Company Redemption Price. The Company Redemption Amount payable pursuant to this Section 6(b) is due in full on the tenth Trading Day following the Optional Prepayment Notice Date (the "OPTIONAL PREPAYMENT DATE"). The Company may only deliver an Optional Prepayment Notice if each of the following shall be true: (i) the Company shall have duly honored all conversions and redemptions scheduled to occur or occurring by virtue of one or more Conversion Notices prior to the Optional Prepayment Notice Date and (ii) the Equity Conditions shall have been satisfied at all times from the Optional Prepayment Notice Date to the Optional Prepayment Date. If any of the foregoing conditions shall cease to be satisfied at any time during the required period, or if the Company shall fail to pay the Optional Prepayment Amount in full by the Optional Prepayment Date, then the Optional Prepayment Notice shall be null and void, ab initio, and the Company may not deliver any subsequent Optional Prepayment Notices. The Holder may convert any portion of this Debenture prior to the Optional Prepayment Date. The Company covenants and agrees that it will honor all Conversion Notices tendered from the time of delivery of the Optional Prepayment Notice through the Optional Prepayment Date.

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7. Ranking. This Debenture ranks pari passu to all other Debentures now or

hereafter issued pursuant to the Transaction Documents. No Indebtedness of the Company is senior to this Debenture in right of payment, whether with respect of interest, damages or upon Liquidation or dissolution or otherwise.

8. Secured Obligations. The payment obligations under this Debenture are

secured pursuant to the Security Agreements. Such agreements will terminate, with respect to the Holder, upon the date on which all payments hereunder have been made in full or the Debenture has otherwise been converted pursuant to the terms hereof.

9. Restricted Actions. Neither the Company nor any subsidiary shall taken

any Restricted Action without the prior written consent of the holders of the Debentures.

10. Miscellaneous.

(a) This Debenture shall be binding on and inure to the benefit of the parties hereto and their respective successors and assigns. This Debenture may be amended only in writing signed by the Company and the Holder and their successors and assigns.

(b) Nothing in this Debenture shall be construed to give to any person or corporation other than the Company and the Holder any legal or equitable right, remedy or cause under this Debenture.

(c) All questions concerning the construction, validity, enforcement and interpretation of this Debenture shall be governed by and construed and enforced in accordance with the internal laws of the State of New York, without regard to the principles of conflict of laws thereof. Each party agrees that all Proceedings shall be commenced exclusively in the state and federal courts sitting in the City of New York, Borough of Manhattan (the "NEW YORK COURTS"). Each party hereto hereby irrevocably submits to the exclusive jurisdiction of the New York Courts for any proceeding, and hereby irrevocably waives, and agrees not to assert in any Proceeding, any claim that it is not personally subject to the jurisdiction of any New York Court or that a New York Court is an inconvenient forum for such Proceeding. Each party hereto hereby irrevocably waives personal service of process and consents to process being served in any such Proceeding by mailing a copy thereof via registered or certified mail or overnight delivery (with evidence of delivery) to such party at the address in effect for notices to it under this Debenture and agrees that such service shall constitute good and sufficient service of process and notice thereof. Nothing contained herein shall be deemed to limit in any way any right to serve process in any manner permitted by law. Each party hereto hereby irrevocably waives, to the fullest extent permitted by applicable law, any and all right to trial by jury in any legal Proceeding. If either party shall commence a Proceeding, then the prevailing party in such Proceeding shall be reimbursed by the other party for its attorney's fees and other costs and expenses incurred with the investigation, preparation and prosecution of such Proceeding.

(d) The headings herein are for convenience only, do not constitute a part of this Debenture and shall not be deemed to limit or affect any of the provisions hereof.

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(e) In case any one or more of the provisions of this Debenture shall be invalid or unenforceable in any respect, the validity and enforceability of the remaining terms and provisions of this Debenture shall not in any way be affected or impaired thereby and the parties will attempt in good faith to agree upon a valid and enforceable provision which shall be a commercially reasonable substitute therefor, and upon so agreeing, shall incorporate such substitute provision in this Debenture.

(f) No provision of this Debenture may be waived or amended except in a written instrument signed, in the case of an amendment, by the Company and the Holder or, or, in the case of a waiver, by the Holder. No waiver of any default with respect to any provision, condition or requirement of this Debenture shall be deemed to be a continuing waiver in the future or a waiver of any subsequent default or a waiver of any other provision, condition or requirement hereof, nor shall any delay or omission of either party to exercise any right hereunder in any manner impair the exercise of any such right.

(g) If it shall be found that any interest due hereunder shall violate applicable laws governing usury, the applicable rate of interest due hereunder shall be reduced to the maximum permitted rate of interest under such law.

(h) Except pursuant to the terms of this Debenture, the outstanding principal amount and interest under this Debenture may not be prepaid by the Company without the prior written consent of the Holder.

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SIGNATURE PAGE FOLLOWS]

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IN WITNESS WHEREOF, the Company has caused this Debenture to be duly executed by a duly authorized officer as of the date first above indicated.

ELECTRIC FUEL CORPORATION

By: _____
 Name:
 Title:

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EXHIBIT A

CONVERSION NOTICE

(To be Executed by the Registered Holder
 in order to convert Debentures)

The undersigned hereby elects to convert the principal amount of Debenture indicated below, into shares of Common Stock of Electric Fuel Corporation as of the date written below. If shares are to be issued in the name of a Person other than undersigned, the undersigned will pay all transfer taxes payable with respect thereto and is delivering herewith such certificates and opinions as reasonably requested by the Company in accordance therewith. No fee will be charged to the Holder for any conversion, except for such transfer taxes, if any. All terms used in this notice shall have the meanings set forth in the Debenture.

By the delivery of this Conversion Notice, the Holder represents and warrants to the Company that its ownership of the shares of Common Stock does not exceed the restrictions set forth in Sections 5(b) of the Debenture.

Conversion calculations:

 Date to Effect Conversion

 Principal amount of Debenture owned prior to conversion

 Principal amount of Debenture to be Converted

 Principal amount of Debenture remaining after
 Conversion

 Number of shares of Common Stock to be Issued

Conversion Price _____

Signature _____

Name

Address

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SCHEDULE 1

CONVERSION SCHEDULE

9% Secured Convertible Debenture, due June 30, 2005, in the aggregate principal amount of \$_____ issued by Electric Fuel Corporation. This Conversion Schedule reflects conversions made under the above referenced Debenture.

Dated: December 31, 2002

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Date of Conversion	Amount of Conversion	Aggregate Principal Amount Remaining Subsequent to Conversion	App Con
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Exhibit 4.3

NEITHER THESE SECURITIES NOR THE SECURITIES INTO WHICH THESE SECURITIES ARE EXERCISABLE HAVE BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE SECURITIES COMMISSION OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS AS EVIDENCED BY A LEGAL OPINION OF COUNSEL TO THE TRANSFEROR TO SUCH EFFECT, THE SUBSTANCE OF WHICH SHALL BE REASONABLY ACCEPTABLE TO THE COMPANY. THESE SECURITIES AND THE SECURITIES ISSUABLE UPON EXERCISE OF THESE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT OR OTHER LOAN SECURED BY SUCH SECURITIES.

ELECTRIC FUEL CORPORATION

WARRANT

Warrant No. [] Date of Original Issuance: December 31, 2002

Electric Fuel Corporation, a Delaware corporation (the "COMPANY"), hereby certifies that, for value received, [] or its registered assigns (the "HOLDER"), is entitled to purchase from the Company up to a total of [] (1) shares of common stock, \$.01 par value (the "COMMON STOCK"), of the Company (each such share, a "WARRANT SHARE" and all such shares, the "WARRANT SHARES") at an exercise price equal to \$[](2) per share (as adjusted from time to time as provided in Section 9, the "EXERCISE PRICE"), at any time and from

 time to time from and after the date hereof and through and including December 31, 2007 (the "EXPIRATION DATE"), and subject to the following terms and conditions:

-
- (1) Each Purchaser shall receive three Warrants each for 1,666,700 multiplied by such Purchaser's Percentage.
 - (2) Warrant I - the Exercise Price shall equal \$0.84.
 Warrant II - the Exercise Price shall equal \$0.89.
 Warrant III - the Exercise Price shall equal \$0.93.

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1. Definitions. In addition to the terms defined elsewhere in this

 Warrant, capitalized terms that are not otherwise defined herein shall have the meanings given to such terms in the Securities Purchase Agreement of even date herewith to which the Company and the original Holder are parties (the "PURCHASE AGREEMENT").

2. Registration of Warrant. The Company shall register this Warrant,

upon records to be maintained by the Company for that purpose (the "WARRANT REGISTER"), in the name of the record Holder hereof from time to time. The Company may deem and treat the registered Holder of this Warrant as the absolute owner hereof for the purpose of any exercise hereof or any distribution to the Holder, and for all other purposes, absent actual notice to the contrary.

3. Registration of Transfers. The Company shall register the transfer

of any portion of this Warrant in the Warrant Register, upon surrender of this Warrant, with the Form of Assignment attached hereto duly completed and signed, to the Company at its address specified herein. Upon any such registration or transfer, a new Warrant to purchase Common Stock, in substantially the form of this Warrant (any such new Warrant, a "NEW WARRANT"), evidencing the portion of this Warrant so transferred shall be issued to the transferee and a New Warrant evidencing the remaining portion of this Warrant not so transferred, if any, shall be issued to the transferring Holder. The acceptance of the New Warrant by the transferee thereof shall be deemed the acceptance by such transferee of all of the rights and obligations of a holder of a Warrant.

4. Exercise and Duration of Warrants.

This Warrant shall be exercisable by the registered Holder at any time and from time to time on or after the date hereof to and including the Expiration Date. At 6:30 p.m., New York City time on the Expiration Date, the portion of this Warrant not exercised prior thereto shall be and become void and of no value, provided, that if the closing sales price of the Common Stock on the

Expiration Date is greater than 102% of the Exercise Price on the Expiration Date, then this Warrant shall be deemed to have been exercised in full (to the extent not previously exercised) on a "cashless exercise" basis at 6:30 P.M. New York City time on the Expiration Date. The Company may not call or redeem all or any portion of this Warrant without the prior written consent of the Holder.

5. Delivery of Warrant Shares.

(a) To effect conversions hereunder, the Holder shall not be required to physically surrender this Warrant unless the aggregate Warrant Shares represented by this Warrant is being exercised. Upon delivery of the Form of Election to Purchase to the Company (with the attached Warrant Shares Exercise Log) at its address for notice set forth herein and upon payment of the Exercise Price multiplied by the number of Warrant Shares that the Holder intends to purchase hereunder, the Company shall promptly (but in no event later than three Trading Days after the Date of Exercise (as defined herein)) issue and deliver to the Holder, a certificate for the Warrant Shares issuable upon such exercise, which, unless otherwise required by the Purchase Agreement, shall be free of restrictive legends. The Company shall, upon request of the Holder and subsequent to the date on which a registration statement covering the resale of the Warrant Shares has been declared effective by the Securities and Exchange Commission, use its best efforts to deliver Warrant Shares hereunder

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electronically through the Depository Trust Company or another established clearing corporation performing similar functions, if available, provided, that, the Company may, but will not be required to change its transfer agent if its current transfer agent cannot deliver Warrant Shares electronically through the Depository Trust Company. A "DATE OF EXERCISE" means the date on which the Holder shall have delivered to Company: (i) the Form of Election to Purchase attached hereto (with the Warrant Exercise Log attached to it), appropriately completed and duly signed and (ii) if such Holder is not utilizing the cashless

exercise provisions set forth in this Warrant, payment of the Exercise Price for the number of Warrant Shares so indicated by the Holder to be purchased.

(b) If by the third Trading Day after a Date of Exercise the Company fails to deliver the required number of Warrant Shares in the manner required pursuant to Section 5(a), then the Holder will have the right to rescind such exercise.

(c) If by the third Trading Day after a Date of Exercise the Company fails to deliver the required number of Warrant Shares in the manner required pursuant to Section 5(a), and if after such third Trading Day and prior to the receipt of such Warrant Shares, the Holder purchases (in an open market transaction or otherwise) shares of Common Stock to deliver in satisfaction of a sale by the Holder of the Warrant Shares which the Holder anticipated receiving upon such exercise (a "BUY-IN"), then the Company shall (1) pay in cash to the Holder the amount by which (x) the Holder's total purchase price (including brokerage commissions, if any) for the shares of Common Stock so purchased exceeds (y) the amount obtained by multiplying (A) the number of Warrant Shares that the Company was required to deliver to the Holder in connection with the exercise at issue by (B) the closing bid price of the Common Stock at the time of the obligation giving rise to such purchase obligation and (2) at the option of the Holder, either reinstate the portion of the Warrant and equivalent number of Warrant Shares for which such exercise was not honored or deliver to the Holder the number of shares of Common Stock that would have been issued had the Company timely complied with its exercise and delivery obligations hereunder. The Holder shall provide the Company written notice indicating the amounts payable to the Holder in respect of the Buy-In.

(d) The Company's obligations to issue and deliver Warrant Shares in accordance with the terms hereof are absolute and unconditional, irrespective of any action or inaction by the Holder to enforce the same, any waiver or consent with respect to any provision hereof, the recovery of any judgment against any Person or any action to enforce the same, or any setoff, counterclaim, recoupment, limitation or termination, or any breach or alleged breach by the Holder or any other Person of any obligation to the Company or any violation or alleged violation of law by the Holder or any other Person, and irrespective of any other circumstance which might otherwise limit such obligation of the Company to the Holder in connection with the issuance of Warrant Shares. Nothing herein shall limit a Holder's right to pursue any other remedies available to it hereunder, at law or in equity including, without limitation, a decree of specific performance and/or injunctive relief with respect to the Company's failure to timely deliver certificates representing shares of Common Stock upon exercise of the Warrant as required pursuant to the terms hereof.

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6. Charges, Taxes and Expenses. Issuance and delivery of certificates

for shares of Common Stock upon exercise of this Warrant shall be made without charge to the Holder for any issue or transfer tax, withholding tax, transfer agent fee or other incidental tax or expense in respect of the issuance of such certificates, all of which taxes and expenses shall be paid by the Company; provided, however, that the Company shall not be required to pay any tax which may be payable in respect of any transfer involved in the registration of any certificates for Warrant Shares or Warrants in a name other than that of the Holder. The Holder shall be responsible for all other tax liability that may arise as a result of holding or transferring this Warrant or receiving Warrant Shares upon exercise hereof.

7. Replacement of Warrant. If this Warrant is mutilated, lost, stolen

or destroyed, the Company shall issue or cause to be issued in exchange and substitution for and upon cancellation hereof, or in lieu of and substitution for this Warrant, a New Warrant, but only upon receipt of evidence reasonably satisfactory to the Company of such loss, theft or destruction and customary and reasonable indemnity (which shall not include a surety bond), if requested. Applicants for a New Warrant under such circumstances shall also comply with such other reasonable regulations and procedures and pay such other reasonable third-party costs as the Company may prescribe. If a New Warrant is requested as a result of a mutilation of this Warrant, then the Holder shall deliver such mutilated Warrant to the Company as a condition precedent to the Company's obligation to issue the New Warrant.

8. Reservation of Warrant Shares. The Company covenants that it will

at all times reserve and keep available out of the aggregate of its authorized but unissued and otherwise unreserved Common Stock, solely for the purpose of enabling it to issue Warrant Shares upon exercise of this Warrant as herein provided, the number of Warrant Shares which are then issuable and deliverable upon the exercise of this entire Warrant, free from preemptive rights or any other contingent purchase rights of persons other than the Holder (taking into account the adjustments and restrictions of Section 9). The Company covenants

that all Warrant Shares so issuable and deliverable shall, upon issuance and the payment of the applicable Exercise Price in accordance with the terms hereof, be duly and validly authorized, issued and fully paid and nonassessable.

9. Certain Adjustments. The Exercise Price and number of Warrant

Shares issuable upon exercise of this Warrant are subject to adjustment from time to time as set forth in this Section 9.

(a) Stock Dividends and Splits. If the Company, at any time while this

Warrant is outstanding, (i) pays a stock dividend on its Common Stock or otherwise makes a distribution on any class of capital stock that is payable in shares of Common Stock, (ii) subdivides outstanding shares of Common Stock into a larger number of shares, or (iii) combines outstanding shares of Common Stock into a smaller number of shares, then in each such case the Exercise Price shall be multiplied by a fraction of which the numerator shall be the number of shares of Common Stock outstanding immediately before such event and of which the denominator shall be the number of shares of Common Stock outstanding immediately after such event. Any adjustment made pursuant to clause (i) of this paragraph shall become effective immediately after the record date for the determination of stockholders entitled to receive such dividend or distribution, and any adjustment pursuant to clause (ii) or (iii) of this paragraph shall

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become effective immediately after the effective date of such subdivision or combination. If any event requiring an adjustment under this paragraph occurs during the period that an Exercise Price is calculated hereunder, then the calculation of such Exercise Price shall be adjusted appropriately to reflect such event.

(b) Pro Rata Distributions. If the Company, at any time while this

Warrant is outstanding, distributes to all holders of Common Stock (i) evidences of its indebtedness, (ii) any security (other than a distribution of Common Stock covered by the preceding paragraph), (iii) rights or warrants to subscribe for or purchase any security, or (iv) any other asset (in each case, "DISTRIBUTED PROPERTY"), then, at the request of any Holder delivered before the 90th day after the record date fixed for determination of stockholders

entitled to receive such distribution, the Company will deliver to such Holder, within five Trading Days after such request (or, if later, on the effective date of such distribution), the Distributed Property that such Holder would have been entitled to receive in respect of the Warrant Shares for which such Holder's Warrant could have been exercised immediately prior to such record date. If such Distributed Property is not delivered to a Holder pursuant to the preceding sentence, then upon any exercise of the Warrant that occurs after such record date, such Holder shall be entitled to receive, in addition to the Warrant Shares otherwise issuable upon such conversion, the Distributed Property that such Holder would have been entitled to receive in respect of such number of Warrant Shares had the Holder been the record holder of such Warrant Shares immediately prior to such record date.

(c) Fundamental Transactions. If, at any time while this Warrant is

outstanding, (1) the Company effects any merger or consolidation of the Company with or into another Person, (2) the Company effects any sale of all or substantially all of its assets in one or a series of related transactions, (3) any tender offer or exchange offer (whether by the Company or another Person) is completed pursuant to which holders of Common Stock are permitted to tender or exchange their shares for other securities, cash or property, or (4) the Company effects any reclassification of the Common Stock or any compulsory share exchange pursuant to which the Common Stock is effectively converted into or exchanged for other securities, cash or property (in any such case, a "FUNDAMENTAL TRANSACTION"), then the Holder shall have the right thereafter to receive, upon exercise of this Warrant, the same amount and kind of securities, cash or property as it would have been entitled to receive upon the occurrence of such Fundamental Transaction if it had been, immediately prior to such Fundamental Transaction, the holder of the number of Warrant Shares then issuable upon exercise in full of this Warrant (the "ALTERNATE CONSIDERATION"). For purposes of any such exercise, the determination of the Exercise Price shall be appropriately adjusted to apply to such Alternate Consideration based on the amount of Alternate Consideration issuable in respect of one share of Common Stock in such Fundamental Transaction, and the Company shall apportion the Exercise Price among the Alternate Consideration in a reasonable manner reflecting the relative value of any different components of the Alternate Consideration. If holders of Common Stock are given any choice as to the securities, cash or property to be received in a Fundamental Transaction, then the Holder shall be given the same choice as to the Alternate Consideration it receives upon any exercise of this Warrant following such Fundamental Transaction. At the Holder's option and request, any successor to the Company or surviving entity in such Fundamental Transaction shall, either (1) issue to the Holder a new warrant substantially in the form of this Warrant and consistent with the foregoing provisions and evidencing the Holder's right to purchase the Alternate Consideration for the aggregate Exercise Price upon exercise thereof, or (2) purchase the Warrant from the Holder for a purchase

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price, payable in cash within five Trading Days after such request (or, if later, on the effective date of the Fundamental Transaction), equal to the Black Scholes value of the remaining unexercised portion of this Warrant on the date of such request. The terms of any agreement pursuant to which a Fundamental Transaction is effected shall include terms requiring any such successor or surviving entity to comply with the provisions of this paragraph (c) and insuring that the Warrant (or any such replacement security) will be similarly adjusted upon any subsequent transaction analogous to a Fundamental Transaction.

(e) Number of Warrant Shares. Simultaneously with any adjustment to

the Exercise Price pursuant to paragraphs (a) or (b) of this Section, the number of Warrant Shares that may be purchased upon exercise of this Warrant shall be increased or decreased proportionately, so that after such adjustment the

aggregate Exercise Price payable hereunder for the adjusted number of Warrant Shares shall be the same as the aggregate Exercise Price in effect immediately prior to such adjustment.

(f) Calculations. All calculations under this Section 9 shall be made to

the nearest cent or the nearest 1/100th of a share, as applicable. The number of shares of Common Stock outstanding at any given time shall not include shares owned or held by or for the account of the Company, and the disposition of any such shares shall be considered an issue or sale of Common Stock.

(g) Notice of Adjustments. Upon the occurrence of each adjustment pursuant

to this Section 9, the Company at its expense will promptly compute such

adjustment in accordance with the terms of this Warrant and prepare a certificate setting forth such adjustment, including a statement of the adjusted Exercise Price and adjusted number or type of Warrant Shares or other securities issuable upon exercise of this Warrant (as applicable), describing the transactions giving rise to such adjustments and showing in detail the facts upon which such adjustment is based. Upon written request, the Company will promptly deliver a copy of each such certificate to the Holder and to the Company's Transfer Agent.

(h) Notice of Corporate Events. If the Company (i) declares a dividend or

any other distribution of cash, securities or other property in respect of its Common Stock, including without limitation any granting of rights or warrants to subscribe for or purchase any capital stock of the Company or any Subsidiary, (ii) authorizes or approves, enters into any agreement contemplating or solicits stockholder approval for any Fundamental Transaction or (iii) authorizes the voluntary dissolution, liquidation or winding up of the affairs of the Company, then the Company shall deliver to the Holder a notice describing the material terms and conditions of such transaction, at least 20 calendar days prior to the applicable record or effective date on which a Person would need to hold Common Stock in order to participate in or vote with respect to such transaction, and the Company will take all steps reasonably necessary in order to insure that the Holder is given the practical opportunity to exercise this Warrant prior to such time so as to participate in or vote with respect to such transaction; provided, however, that the failure to deliver such notice or any defect therein shall not affect the validity of the corporate action required to be described in such notice.

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10. Payment of Exercise Price. The Holder may pay the Exercise Price in one

of the following manners:

(a) Cash Exercise. The Holder may deliver immediately available funds;

or

(b) Cashless Exercise. At any time after the earlier to occur of the

Effectiveness Date (as defined in the Registration Rights Agreement (as defined in the Purchase Agreement)) and the date such registration statement filed pursuant to the Registration Rights Agreement is declared effective by the Commission, when a registration statement covering the resale of the Warrant Shares and naming the Holder as a selling stockholder thereunder or the prospectus included therein, is not then effective, the Holder may surrender this Warrant to the Company together with a notice of cashless exercise, in which event the Company shall issue to the Holder the number of Warrant Shares

determined as follows:

$$X = Y [(A-B)/A]$$

where:

X = the number of Warrant Shares to be issued to the Holder.

Y = the number of Warrant Shares with respect to which this Warrant is being exercised.

A = the average of the closing prices for the five Trading Days immediately prior to (but not including) the Exercise Date.

B = the Exercise Price.

For purposes of Rule 144 promulgated under the Securities Act, it is intended, understood and acknowledged that the Warrant Shares issued in a cashless exercise transaction shall be deemed to have been acquired by the Holder, and the holding period for the Warrant Shares shall be deemed to have commenced, on the date this Warrant was originally issued.

11. Limitation on Exercise.

(a) Notwithstanding anything to the contrary contained herein, the number of shares of Common Stock that may be acquired by the Holder upon any exercise of this Warrant (or otherwise in respect hereof) shall be limited to the extent necessary to insure that, following such exercise (or other issuance), the total number of shares of Common Stock then beneficially owned by such Holder and its Affiliates and any other Persons whose beneficial ownership of Common Stock would be aggregated with the Holder's for purposes of Section 13(d) of the Exchange Act, does not exceed 4.999% of the total number of issued and outstanding shares of Common Stock (including for such purpose the shares of Common Stock issuable upon such exercise). For such purposes, beneficial ownership shall be determined in accordance with Section 13(d) of the Exchange Act and the rules and regulations promulgated thereunder. Each delivery of an Exercise Notice hereunder will constitute a representation by the Holder that it has evaluated the limitation set forth in this paragraph and determined that issuance of the full number of Warrant Shares requested in such Exercise Notice is permitted under this paragraph. By written notice to the Company, the Holder

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may waive the provisions of this Section but (i) any such waiver will not be effective until the 61st day after such notice is delivered to the Company, and (ii) any such waiver will apply only to the Holder and not to any other holder of Warrants. This provision shall not restrict the number of shares of Common Stock which a Holder may receive or beneficially own in order to determine the amount of securities or other consideration that such Holder may receive in the event of a merger or other business combination or reclassification involving the Company as contemplated in Section 9 of this Warrant.

(b) Notwithstanding anything to the contrary contained herein, the number of shares of Common Stock that may be acquired by the Holder upon any exercise of this Warrant (or otherwise in respect hereof) shall be limited to the extent necessary to insure that, following such exercise (or other issuance), the total number of shares of Common Stock then beneficially owned by such Holder and its Affiliates and any other Persons whose beneficial ownership of Common Stock would be aggregated with the Holder's for purposes of Section 13(d) of the Exchange Act, does not exceed 9.999% of the total number of issued and outstanding shares of Common Stock (including for such purpose the shares of

Common Stock issuable upon such exercise). For such purposes, beneficial ownership shall be determined in accordance with Section 13(d) of the Exchange Act and the rules and regulations promulgated thereunder. Each delivery of an Exercise Notice hereunder will constitute a representation by the Holder that it has evaluated the limitation set forth in this paragraph and determined that issuance of the full number of Warrant Shares requested in such Exercise Notice is permitted under this paragraph. This provision shall not restrict the number of shares of Common Stock which a Holder may receive or beneficially own in order to determine the amount of securities or other consideration that such Holder may receive in the event of a merger or other business combination or reclassification involving the Company as contemplated in Section 9 of this Warrant.

12. No Fractional Shares. No fractional shares of Warrant Shares will be

issued in connection with any exercise of this Warrant. In lieu of any fractional shares which would, otherwise be issuable, the Company shall pay cash equal to the product of such fraction multiplied by the closing price of one Common Stock as reported on the Trading Market on the date of exercise.

13. Notices. Any and all notices or other communications or deliveries

hereunder (including without limitation any Exercise Notice) shall be in writing and shall be deemed given and effective on the earliest of (i) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section prior to 6:30 p.m. (New York City time) on a Trading Day, (ii) the next Trading Day after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number specified in this Section on a day that is not a Trading Day or later than 6:30 p.m. (New York City time) on any Trading Day, (iii) the Trading Day following the date of mailing, if sent by nationally recognized overnight courier service, or (iv) upon actual receipt by the party to whom such notice is required to be given. The addresses for such communications shall be: (i) if to the Company, to Electric Fuel Corporation, 632 Broadway, Suite 301, New York, NY 10012; Facsimile No.: (212) 529-5800, Attn.: Chief Financial Officer and

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General Counsel, with a copy to Electric Fuel (E.F.L.) Ltd., Western Industrial Zone, Beit Shemesh 99000, Israel, Facsimile No.: 011-972-2-990-6688, Attn.: Chief Financial Officer and General Counsel or (ii) if to the Holder, to the address or facsimile number appearing on the Warrant Register or such other address or facsimile number as the Holder may provide to the Company in accordance with this Section.

14. Warrant Agent. The Company shall serve as warrant agent under this

Warrant. Upon 30 days' notice to the Holder, the Company may appoint a new warrant agent. Any corporation into which the Company or any new warrant agent may be merged or any corporation resulting from any consolidation to which the Company or any new warrant agent shall be a party or any corporation to which the Company or any new warrant agent transfers substantially all of its corporate trust or shareholders services business shall be a successor warrant agent under this Warrant without any further act. Any such successor warrant agent shall promptly cause notice of its succession as warrant agent to be mailed (by first class mail, postage prepaid) to the Holder at the Holder's last address as shown on the Warrant Register.

15. Miscellaneous.

(a) This Warrant shall be binding on and inure to the benefit of the

parties hereto and their respective successors and assigns. Subject to the preceding sentence, nothing in this Warrant shall be construed to give to any Person other than the Company and the Holder any legal or equitable right, remedy or cause of action under this Warrant. This Warrant may be amended only in writing signed by the Company and the Holder and their successors and assigns.

(b) All questions concerning the construction, validity, enforcement and interpretation of this Warrant shall be governed by and construed and enforced in accordance with the internal laws of the State of New York, without regard to the principles of conflict of laws thereof. Each party agrees that all legal proceedings concerning the interpretations, enforcement and defense of the transactions contemplated by this Warrant (whether brought against a party hereto or its respective affiliates, directors, officers, shareholders, employees or agents) shall be commenced in the state and federal courts sitting in the City of New York, Borough of Manhattan. Each party hereto hereby irrevocably submits to the exclusive jurisdiction of the state and federal courts sitting in the City of New York, Borough of Manhattan for the adjudication of any dispute hereunder or in connection herewith or with any transaction contemplated hereby or discussed herein (including with respect to the enforcement of this Warrant), and hereby irrevocably waives, and agrees not to assert in any suit, action or proceeding, any claim that it is not personally subject to the jurisdiction of any such court, or that such suit, action or proceeding has been commenced in an improper or inconvenient forum. Each party hereto hereby irrevocably waives personal service of process and consents to process being served in any such suit, action or proceeding by mailing a copy thereof via registered or certified mail or overnight delivery (with evidence of delivery) to such party at the address in effect for notices to it under this Warrant and agrees that such service shall constitute good and sufficient service of process and notice thereof. Nothing contained herein shall be deemed to limit in any way any right to serve process in any manner permitted by law. Each party hereto (including its affiliates, agents, officers, directors and employees) hereby irrevocably waives, to the fullest extent permitted by

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applicable law, any and all right to trial by jury in any legal proceeding arising out of or relating to this Warrant or the transactions contemplated hereby. If either party shall commence an action or proceeding to enforce any provisions of this Warrant, then the prevailing party in such action or proceeding shall be reimbursed by the other party for its reasonable attorneys fees and other actual costs and expenses incurred with the investigation, preparation and prosecution of such action or proceeding.

(c) The headings herein are for convenience only, do not constitute a part of this Warrant and shall not be deemed to limit or affect any of the provisions hereof.

(d) In case any one or more of the provisions of this Warrant shall be invalid or unenforceable in any respect, the validity and enforceability of the remaining terms and provisions of this Warrant shall not in any way be affected or impaired thereby and the parties will attempt in good faith to agree upon a valid and enforceable provision which shall be a commercially reasonable substitute therefor, and upon so agreeing, shall incorporate such substitute provision in this Warrant.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK,
SIGNATURE PAGE FOLLOWS]

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IN WITNESS WHEREOF, the Company has caused this Warrant to be duly executed by its authorized officer as of the date first indicated above.

ELECTRIC FUEL CORPORATION

By: _____

Name:

Title:

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FORM OF ELECTION TO PURCHASE

To Electric Fuel Corporation:

The undersigned hereby irrevocably elects to purchase _____ shares of common stock, \$0.01 par value per share, of Electric Fuel Corporation ("COMMON STOCK"), pursuant to Warrant No. [], original issued [], 2002 (the "WARRANT"), and, if such Holder is not utilizing the cashless exercise provisions set forth in the Warrant, encloses herewith \$_____ in cash, certified or official bank check or checks or other immediately available funds, which sum represents the aggregate Exercise Price (as defined in the Warrant) for the number of shares of Common Stock to which this Form of Election to Purchase relates, together with any applicable taxes payable by the undersigned pursuant to the Warrant.

By its delivery of this Form of Election To Purchase, the undersigned represents and warrants to the Company that in giving effect to the exercise evidenced hereby the Holder will not beneficially own in excess of the number of shares of Common Stock (determined in accordance with Section 13(d) of the Securities Exchange Act of 1934) permitted to be owned under Section 11 of this Warrant to which this notice relates.

The undersigned requests that certificates for the shares of Common Stock issuable upon this exercise be issued in the name of

PLEASE INSERT SOCIAL SECURITY OR
TAX IDENTIFICATION NUMBER

(Please print name and address)

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Date	Number of Warrant Shares Available to be Exercised	Number of Warrant Shares Exercised	Number of Warrant Shares Remaining to be Exercised
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<S>	<C>	<C>	<C>

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FORM OF ASSIGNMENT

[To be completed and signed only upon transfer of Warrant]

FOR VALUE RECEIVED, the undersigned hereby sells, assigns and transfers unto _____ the right represented by the within Warrant to purchase _____ shares of Common Stock of Electric Fuel Corporation to which the within Warrant relates and appoints _____ attorney to transfer said right on the books of Electric Fuel Corporation with full power of substitution in the premises.

Dated: _____, ____

 (Signature must conform in all respects to name of
 holder as specified on the
 face of the Warrant)

 Address of Transferee

In the presence of:

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Exhibit 4.4

SECURITY AGREEMENT

SECURITY AGREEMENT, dated as of December 31, 2002, between Electric Fuel Corporation, a Delaware corporation (the "PARENT"), Electric Fuel Transportation Corp., a Delaware corporation ("EFT"), Electric Fuel B.V., a Netherlands corporation ("EF-BV"), Instant Power Corporation, a Delaware corporation ("IPC"), I.E.S. Defense Services, Inc., a Delaware corporation ("IDS"), IES Interactive Training, Inc. ("IES"), Electric Fuel GmbH, a German corporation ("EF-G"), Summit Training International, Inc., a Delaware corporation ("STI"), Electric Fuel UK Ltd., a British corporation ("EF-UK") (each of EFT, EF-BV, IPC, IDS, IES, EF-G, STI and EF-UK, a "SUBSIDIARY" and, together with Parent, the "DEBTORS") and the investors signatory hereto (each investor including their respective successors, endorsees, transferees and assigns, a "SECURED PARTY", and collectively, the "SECURED PARTIES").

W I T N E S S E T H:

WHEREAS, pursuant to the Securities Purchase Agreement, dated the date hereof between the Parent and the Secured Parties (the "PURCHASE AGREEMENT"), the Secured Parties have agreed to extend certain loans to the Parent which shall be evidenced by the issuance to the Secured Parties of Secured Convertible Debentures, due June 30, 2005 (the "DEBENTURES"); and

WHEREAS, in order to induce the Secured Parties to enter into the Purchase Agreement, the Debtors have agreed to execute and deliver to the Secured Parties this Agreement and a separate security agreement with respect to the Debtors' intellectual property ("IP SECURITY AGREEMENT") for the benefit of the Secured Parties and to grant to it a first priority security interest in certain property of the Debtors to secure the prompt payment, performance and discharge in full of all of the Parent's obligations under the Debentures, this Agreement and the IP Security Agreement.

NOW, THEREFORE, in consideration of the agreements herein contained and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto hereby agree as follows:

1. Certain Definitions. As used in this Agreement, the following terms

shall have the meanings set forth in this Section 1. Terms used but not otherwise defined in this Agreement that are defined in Article 9 of the UCC (such as "GENERAL INTANGIBLES" and "PROCEEDS") shall have the respective meanings given such terms in Article 9 of the UCC.

(a) "ACCOUNTS" shall mean all present and future rights of the Debtors to payment for goods sold or leased or for services rendered, which are not evidenced by instruments or chattel paper, and whether or not earned by performance.

(b) "AGENT" means ZLP Master Technology Fund as agent for each of the Secured Parties pursuant to this Agreement and the IP Security Agreement, or such other Person as shall have been subsequently appointed as a successor agent pursuant to this Agreement.

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(c) "COLLATERAL" means the collateral in which the Secured Parties are granted a first priority security interest by this Agreement and which shall include the following, whether presently owned or existing or hereafter acquired or coming into existence, and all additions and accessions thereto and all substitutions and replacements thereof, and all proceeds, products and Accounts thereof, including, without limitation, all proceeds from the sale or transfer of the Collateral and of insurance covering the same and of any tort claims in connection therewith:

(i) All Goods of the Debtors, including, without limitations, all machinery, equipment, computers, motor vehicles, trucks, tanks, boats, ships, appliances, furniture, special and general tools, fixtures, test and quality control devices and other equipment of every kind and nature and wherever situated, together with all documents of title and documents representing the same, all additions and accessions thereto, replacements therefor, all parts therefor, and all substitutes for any of the foregoing and all other items used and useful in connection with the Debtors' businesses and all improvements thereto (collectively, the "EQUIPMENT"); and

(ii) All Inventory of the Debtors; and

(iii) All of the Debtors' contract rights and general intangibles, including, without limitation, all partnership interests, stock or other securities, licenses, distribution and other agreements, computer software development rights, leases, franchises, customer lists, quality control procedures, grants and rights, goodwill, trademarks, service marks, trade styles, trade names, patents, patent applications, copyrights, deposit accounts, and income tax refunds (collectively, the "GENERAL INTANGIBLES"); and

(iv) All Accounts of the Debtors including all insurance proceeds, and rights to refunds or indemnification whatsoever owing, together with all instruments, all documents of title representing any of the foregoing, all rights in any merchandising, goods, equipment, motor vehicles and trucks which any of the same may represent, and all right, title, security and guaranties with respect to each Receivable, including any right of stoppage in transit;

(v) All Pledged Shares; and

(vi) All of the Debtors' documents, instruments and chattel paper, files, records, books of account, business papers, computer programs and the products and proceeds of all of the foregoing Collateral set forth in clauses (i)-(v) above.

(d) "OBLIGATIONS" means all of the Debtors' obligations under this Agreement, the Debentures and the IP Security Agreement, in each case, whether now or hereafter existing, voluntary or involuntary, direct or indirect, absolute or contingent, liquidated or unliquidated, whether or not jointly owed with others, and whether or not from time to time decreased or extinguished and later increased, created or incurred, and all or any portion of such obligations or liabilities that are paid, to the extent all or any part of such payment is avoided or recovered directly or indirectly from the Secured Parties as a preference, fraudulent transfer or otherwise as such obligations may be amended, supplemented, converted, extended or modified from time to time.

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(e) "PLEGDED SHARES" means (i) all the shares of common stock of each of

the Subsidiaries of which the Parent is the direct or indirect beneficial and record holder and set forth on Schedule C attached hereto, (ii) all additional

 shares of each of the Subsidiaries from time to time acquired by the Parent in any manner; (ii) the certificates representing the shares referred to in clauses (i) and (ii) above; and (iii) subject to Section 4, all dividends, cash, instruments, options, rights and other property or proceeds, from time to time received, receivable or otherwise distributed or distributable in respect of or in exchange for any or all of the shares referred to in clauses (i) and (ii) above.

(f) "UCC" means the Uniform Commercial Code and/or any other applicable law of each jurisdiction in which any Debtor is incorporated or organized (including, without limitation the State of Delaware) and any jurisdiction as to any Collateral located therein.

2. Grant of Security Interest.

 (a) As an inducement for the Secured Parties to enter into the Purchase Agreement and to secure the complete and timely payment, performance and discharge in full, as the case may be, of all of the Obligations, each of the Debtors hereby, unconditionally and irrevocably, pledges, grants and hypothecates to the Secured Parties, a continuing first priority security interest in, a first lien upon and a right of set-off against all of the Debtors' right, title and interest of whatsoever kind and nature in and to the Collateral (the "SECURITY INTEREST").

(b) Concurrently with or promptly following the execution of this Agreement, all certificates or instruments representing or evidencing the Pledged Shares shall be delivered to and held by the Secured Parties pursuant to this Agreement and shall be accompanied by undated stock powers duly endorsed in blank and irrevocable proxies; provided, however, that the Company shall use its best effort to deliver the certificates evidencing its ownership of IDS as soon as possible.

3. Representations, Warranties, Covenants and Agreements of the Debtors. The

 Debtors jointly and severally represent and warrant to, and covenant and agree with, the Secured Parties as follows:

(a) Each Debtor has the requisite corporate power and authority to enter into this Agreement and otherwise to carry out its obligations thereunder. The execution, delivery and performance by each Debtor of this Agreement and the filings contemplated therein have been duly authorized by all necessary action on the part of such Debtor and no further action is required by such Debtor.

(b) Each Debtor represents and warrants that it has no place of business or offices where its respective books of account and records are kept (other than temporarily at the offices of its attorneys or accountants) or places where Collateral is stored or located, except as set forth on Schedule A attached

 hereto;

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(c) (i) Except for the Security Interest and as set forth in Schedule

 3(c)(i) hereto, each Debtor is the sole owner of the Collateral (except for

 non-exclusive licenses granted by the Debtors in the ordinary course of business), free and clear of any liens, security interests, encumbrances, rights

or claims, and is fully authorized to grant the Security Interest in and to pledge the Collateral. There is not on file in any governmental or regulatory authority, agency or recording office an effective financing statement, security agreement, license or transfer or any notice of any of the foregoing (other than those that have been filed in favor of the Secured Parties pursuant to this Agreement) covering or affecting any of the Collateral. So long as this Agreement shall be in effect, the Debtors shall not execute and shall not knowingly permit to be on file in any such office or agency any such financing statement or other document or instrument (except to the extent filed or recorded in favor of the Secured Parties pursuant to the terms of this Agreement).

(ii) The Parent is the record, direct and beneficial owner of the Pledged Shares (other than STI, which is wholly-owned by IES). Except as set forth in Schedule 3(c)(ii) hereto, all of the Pledged Shares are owned by the

Parent or its subsidiary, as the case may be, free and clear of any lien, claim, encumbrance, security interest, right or other charge, other than the Security Interest granted to the Secured Parties hereunder. The Parent has the power, authority and legal right to pledge, assign, transfer, deliver, deposit and set over the Pledged Shares pledged to the Secured Parties as provided herein.

(d) No part of the Collateral has been judged invalid or unenforceable. No written claim has been received that any Collateral or the Debtors' use of any Collateral violates the rights of any third party. There has been no adverse decision to the Debtors' claim of ownership rights in or exclusive rights to use the Collateral in any jurisdiction or to the Debtors' right to keep and maintain such Collateral in full force and effect, and there is no proceeding involving said rights pending or, to the best knowledge of the Debtors, threatened before any court, judicial body, administrative or regulatory agency, arbitrator or other governmental authority.

(e) Each Debtor shall at all times maintain its books of account and records relating to the Collateral at its principal place of business and its Collateral at the locations set forth on Schedule A attached hereto and may not

relocate such books of account and records or tangible Collateral unless it delivers to each of the Secured Parties at least 30 days prior to such relocation (i) written notice of such relocation and the new location thereof (which must be within the United States) and (ii) evidence that appropriate financing statements under the UCC and other necessary documents have been filed and recorded and other steps have been taken to perfect the Security Interest to create in favor of each of the Secured Parties a valid, perfected and continuing first priority liens in the Collateral. The principal place of business of each of the Debtors is located at the address set forth in Schedule A hereto, and will

not be moved without notice to each Secured Party.

(f) This Agreement creates in favor of the Secured Parties a valid security interest in the Collateral securing the payment and satisfaction of the Obligations and, upon making the filings described in the immediately following sentence, a perfected first priority security interest in such Collateral. Except for the filing of financing statements pursuant to the UCC with the proper filing and recording agencies in the jurisdictions indicated on Schedule

B, attached hereto, no authorization or approval of or filing with or notice to

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any governmental authority or regulatory body is required either (i) for the grant by the Debtors of, or the effectiveness of, the Security Interest granted

hereby or for the execution, delivery and performance of this Agreement by the Debtors or (ii) for the perfection of or exercise by the Secured Parties of its rights and remedies hereunder.

(g) The Debtors acknowledge and agree that on the date of execution of this Agreement, the Secured Parties will file one or more financing statements under the UCC with respect to the Security Interest with the proper filing and recording agencies in the jurisdictions indicated on Schedule B, attached hereto

and in such other jurisdictions as the Secured Parties may deem necessary.

(h) The execution, delivery and performance of this Agreement does not conflict with or cause a breach or default, or an event that with or without the passage of time or notice, shall constitute a breach or default, under any agreement to which the Debtors are a party or by which the Debtors are bound. No consent (including, without limitation, from stock holders or creditors of the Debtors) is required for the Debtors to enter into and perform their obligations hereunder.

(i) The Debtors shall at all times maintain the liens and Security Interest provided for hereunder as valid and perfected first priority liens and security interests in the Collateral in favor of each of the Secured Parties to ensure that such liens and Security Interest are and remain senior to all not existing and hereafter created security interests and liens. The Collateral will be kept free of all liens, security interest, claims and encumbrances whatsoever. Each Debtor hereby agrees to defend the same against any and all persons. Each Debtor shall safeguard and protect all Collateral for the account of the Secured Parties. At the request of the Agent and/or the Secured Parties, the Debtors will sign and deliver to the Secured Parties at any time or from time to time one or more financing statements pursuant to the UCC in form reasonably satisfactory to the Secured Parties and will pay the cost of filing the same in all public offices wherever filing is, or is deemed by the Secured Parties to be, necessary or desirable to effect the rights and obligations provided for herein. Without limiting the generality of the foregoing, the Debtors shall pay all fees, taxes and other amounts necessary to maintain the Collateral and the Security Interest hereunder, and the Debtors shall obtain and furnish to the Secured Parties from time to time, upon demand, such releases and/or subordinations of claims and liens which may be required to maintain the priority of the Security Interest hereunder.

(j) The Debtors will not allow any Collateral to be abandoned, forfeited or dedicated to the public without the prior written consent of the Secured Parties. The Debtors will not transfer, pledge, hypothecate, encumber, license (except for non-exclusive licenses granted by the Debtors in the ordinary course of business), sell or otherwise dispose of any of the Collateral without the prior written consent of the Secured Parties.

(k) Each Debtor shall keep and preserve its Equipment, Inventory and other tangible Collateral in good condition, repair and order and shall not operate or locate any such Collateral (or cause to be operated or located) in any area excluded from insurance coverage.

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(l) Each Debtor shall, within ten (10) days of obtaining knowledge thereof, advise the Agent, in sufficient detail, of any substantial change in the Collateral, and of the occurrence of any event which would have a material adverse effect on the value of the Collateral or on the Secured Parties' security interest therein.

(m) Each Debtor shall promptly execute and deliver to the Secured Parties such further deeds, mortgages, assignments, security agreements, financing statements or other instruments, documents, certificates and assurances and take

such further action as the Secured Parties may from time to time request and may in its sole discretion deem necessary to perfect, protect or enforce its security interest in the Collateral including, without limitation, the IP Security Agreement in which each the Secured Parties has been granted a security interest hereunder, substantially in a form acceptable to the Secured Parties, which IP Security Agreement, other than as stated therein, shall be subject to all of the terms and conditions hereof.

(n) The Debtors shall permit the Secured Parties and its representatives and agents upon reasonable prior notice to inspect the Collateral at any time during normal business hours, and to make copies of records pertaining to the Collateral as may be requested by the Secured Parties from time to time.

(o) Each Debtor will, at its own expense, take all steps reasonably necessary to diligently pursue and seek to preserve, enforce and collect any rights, claims, causes of action and accounts receivable in respect of the Collateral.

(p) Each Debtor shall promptly notify the Secured Parties in sufficient detail upon becoming aware of any attachment, garnishment, execution or other legal process levied against any Collateral and of any other information received by the Debtors that may materially affect the value of the Collateral, the Security Interest or the rights and remedies of the Secured Parties hereunder.

(q) Each Debtor shall not use or permit any Collateral to be used unlawfully or in violation of any provision of this Agreement or any applicable statute, regulation or ordinance or any policy of insurance covering the Collateral where violation is reasonably likely to have a material adverse effect on the Secured Parties' rights in the Collateral or Secured Parties' ability to foreclose on the Collateral.

(r) The Debtors shall not grant to any person or entity any rights or interests in or to any of the Collateral that are senior to, or pari passu with, the Secured Parties.

(s) Each Debtor shall notify the Agent of any change in such Debtor's name, identity, chief place of business, chief executive office or residence within 10 days prior to such change.

(t) All information heretofore, herein or hereafter supplied to the Secured Parties by or on behalf of the Debtors with respect to the Collateral is accurate and complete in all material respects as of the date furnished.

4. Voting Rights; Dividends; Etc.

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(a) As long as no Event of Default (as defined in Section 5) shall have occurred and be continuing and, in the case of Section 4(b)(i), as long as no notice thereof shall have been given by the Secured Parties to the Parent):

(i) The Parent shall be entitled to exercise any and all voting and other consensual rights pertaining to the Pledged Shares pledged by it hereunder or any part thereof for any purpose not inconsistent with the terms of this Agreement or the Debenture; provided, however, that the Parent shall not exercise or refrain from exercising any such right if such action would have an adverse effect on the value of the Pledged Shares or any part thereof.

(ii) The Parent shall be entitled to receive and retain any and all dividends paid in respect of the Pledged Shares pledged by it hereunder, other than any and all:

(1) dividends paid or payable other than in cash in respect of, and instruments and other property received, receivable or otherwise distributed in respect of, or in exchange for, any Pledged Shares;

(2) dividends and other distributions paid or payable in cash in respect of any Pledged Shares in connection with a partial or total liquidation or dissolution or in connection with a reduction of capital, capital surplus or paid-in-surplus; and

(3) cash paid, payable or otherwise distributed in redemption of, or in exchange for, any Pledged Shares,

all of which shall be, and all of which shall be forthwith delivered to the Secured Parties to hold as Pledged Shares and shall, if received by the Parent, be received in trust for the benefit of the Secured Parties, be segregated from the other property or funds of the Parent, and be forthwith delivered to the Secured Parties as Pledged Shares in the same form as so received (with any necessary endorsement).

(iii) The Secured Parties shall execute and deliver (or cause to be executed and delivered) to the Parent all such proxies and other instruments as the Parent may reasonably request for the purpose of enabling the Parent to exercise the voting and other rights which it is entitled to exercise pursuant to subsection (a)(i) above and to receive the dividends which it is authorized to receive and retain pursuant to subsection (a)(ii) above.

(b) Upon the occurrence and during the continuance of an Event of Default:

(i) All rights of the Parent to exercise the voting and other consensual rights which it would otherwise be entitled to exercise pursuant to Section 4(a)(i) above shall cease upon notice from the Secured Parties to the Parent, and all such rights shall thereupon become vested in the Secured Parties who shall thereupon have the sole right to exercise such voting and other consensual rights and any and all rights of conversion, exchange, subscription or any other rights, privileges or options pertaining to the Pledged Shares or any part thereof, and Secured Parties may exercise such powers in such manner as the Secured Parties may elect, but the Secured Parties shall have no duty to exercise any of the aforesaid right, privileges or options and shall not be responsible for any failure to do so or delay in doing so.

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(ii) All rights of the Parent to receive the dividends which it or he would otherwise be authorized to receive and retain pursuant to Section 4(a)(ii) above shall cease, and all such rights shall thereupon become vested in the Parent who shall thereupon have the sole right to receive and hold as part of the Pledged Shares such dividends.

(iii) All dividends which are received by the Parent contrary to the provisions of paragraph (ii) of this Section 4(b) shall be received in trust for the benefit of the Secured Parties, shall be segregated from other funds of the Parent and shall be forthwith paid over to the Secured Parties as Pledged Shares in the same form as so received (with any necessary endorsement).

(c) In order to permit the Secured Parties to exercise the voting and other rights which it may be entitled to exercise pursuant to Section

4(b)(i) above, and to receive all dividends and distributions which it may be entitled Secured Parties, from time to time execute and deliver to the Secured Parties appropriate proxies, dividend payment orders and other instruments as the Secured Parties may reasonably request.

5. Defaults. The following events shall be "EVENTS OF DEFAULT":

(a) The occurrence of an Event of Default (as defined in the Debentures) under the Debentures;

(b) Any representation or warranty of the Debtors in this Agreement or in the IP Security Agreement shall prove to have been incorrect in any material respect when made; and

(c) The failure by a Debtor to observe or perform any of its obligations hereunder or in the IP Security Agreement for ten (10) days after receipt by a Debtor of notice of such failure from the Secured Parties.

6. Duty To Hold In Trust. Upon the occurrence and the continuation of any

Event of Default, the Debtors shall, upon receipt by it of any revenue, income or other sums subject to the Security Interest, whether payable pursuant to the Debentures or otherwise, or of any check, draft, note, trade acceptance or other instrument evidencing an obligation to pay any such sum, hold the same in trust for the Secured Parties and shall forthwith endorse and transfer any such sums or instruments, or both, to the Secured Parties for application to the satisfaction of the Obligations.

7. Rights and Remedies Upon Default. Upon the occurrence and during the

continuation of any Event of Default, the Agent (on behalf of, and for the benefit of, itself and each of the Secured Parties) shall have the right to exercise all of the remedies conferred hereunder, under the Debentures and under the IP Security Agreement, and the Agent and Secured Parties shall have all the rights and remedies of a secured party under the UCC. Without limitation, the Secured Parties shall have the following rights and powers:

(a) The Agent shall have the right to take possession of all tangible manifestations or embodiments of the Collateral and, for that purpose, enter, with the aid and assistance of any person, any premises where the Collateral, or any part thereof, is or may be placed and remove the same,

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and the Debtors shall assemble the Collateral and make it available to the Agent at places which the Agent shall reasonably select, whether at the Debtors' premises or elsewhere, and make available to the Agent, without rent, all of the Debtors' respective premises and facilities for the purpose of the Agent taking possession of, removing or putting the Collateral in saleable or disposable form.

(b) The Agent shall have the right to operate the business of the Debtors using the Collateral and shall have the right to assign, sell, lease or otherwise dispose of and deliver all or any part of the Collateral, at public or private sale or otherwise, either with or without special conditions or stipulations, for cash or on credit or for future delivery, in such parcel or parcels and at such time or times and at such place or places, and upon such terms and conditions as the Agent may deem commercially reasonable, all without (except as shall be required by applicable statute and cannot be waived) advertisement or demand upon or

notice to the Debtors or right of redemption of the Debtors, which are hereby expressly waived. Upon each such sale, lease, assignment or other transfer of Collateral, the Agent may, unless prohibited by applicable law which cannot be waived, purchase all or any part of the Collateral being sold, free from and discharged of all trusts, claims, right of redemption and equities of the Debtors, which are hereby waived and released.

(c) The Agent may license or, to the same extent the Debtors are permitted by law and contract to do so, sublicense, whether on an exclusive or non-exclusive basis, any of the Collateral throughout the world for such period, on such conditions and in such manner as the Secured Parties shall, in its reasonable discretion, determine.

(d) The Agent may (without assuming any obligations or liabilities thereunder), at any time, enforce (and shall have the exclusive right to enforce) against licensee or sublicensee all rights and remedies of the Debtors in, to and under any license agreement with respect to such Collateral, and take or refrain from taking any action thereunder.

(e) The Agent may, in order to implement the assignment, license, sale or other disposition of any of the Collateral pursuant to this Section, pursuant to the authority provided for in Section 13, execute and deliver on behalf of the Debtors one or more instruments of assignment of the Collateral in form suitable for filing, recording or registration in any jurisdictions as the Secured Parties may determine advisable.

(f) In the event that any Secured Party shall recover from the Debtors or the Collateral more than its pro rata share of the Obligations owed to all Secured Parties hereunder, whether by agreement, understanding or arrangement with the Debtors or any other Person, set off or other means, such Secured Party shall immediately deliver or pay over to the other Secured Parties their pro rata portion of any such recovery in the form received.

(g) Agent may, at any time or times that an Event of Default exists or has occurred and is continuing, (i) notify any or all account debtors that the Accounts have been assigned to Secured Parties and that Secured Parties have a security interest therein and Agent may direct any or all accounts debtors to make payment of Accounts directly to Secured Parties, (ii) extend the time of payment of, compromise, settle or adjust for cash, credit, return of merchandise or otherwise, and upon any terms or

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conditions, any and all Accounts or other obligations included in the Collateral and thereby discharge or release the account debtor or any other party or parties in any way liable for payment thereof without affecting any of the Obligations, (iii) demand, collect or enforce payment of any Accounts or such other obligations, but without any duty to do so, and Agent and Secured Parties shall not be liable for its failure to collect or enforce the payment thereof nor for the negligence of its agents or attorneys with respect thereto and (iv) take whatever other action Agent may deem necessary or desirable for the protection of its interests. At any time that an Event of Default exists or has occurred and is continuing, at Agent's request, all invoices and statements sent to any account debtor shall state that the Accounts and such other obligations have been assigned to Secured Parties and are payable directly and only to Secured Parties and the Debtors shall deliver to Agent such originals of documents evidencing the sale and delivery of goods or the performance of services giving rise to any Accounts as Agent may require.

8. Applications of Proceeds. The proceeds of any such sale, lease, license

or other disposition of the Collateral hereunder shall be applied (i) first, to the expenses of retaking, holding, storing, processing and preparing for sale, selling, and the like (including, without limitation, any taxes, fees and other costs incurred in connection therewith) of the Collateral, (ii) to the reasonable attorneys' fees and expenses incurred by the Agent and/or Secured Parties in enforcing its rights hereunder and in connection with collecting, storing and disposing of the Collateral, (iii) to satisfaction of the Obligations, and (iv) to the payment of any other amounts required by applicable law, after which the Secured Parties shall pay to the Debtors any surplus proceeds. If, upon the sale, license or other disposition of the Collateral, the proceeds thereof are insufficient to pay all amounts to which the Secured Parties are legally entitled, the Debtors will be liable for the deficiency, together with interest thereon, at the rate of 12% per annum or the lesser amount permitted by applicable law (the "DEFAULT RATE"), and the reasonable fees of any attorneys employed by the Agent and/or Secured Parties to collect such deficiency. To the extent permitted by applicable law, each Debtor waives all claims, damages and demands against the Secured Parties arising out of the repossession, removal, retention or sale of the Collateral, unless due to the gross negligence or willful misconduct of the Agent and/or Secured Parties.

9. Costs and Expenses. The Debtors agree to pay all out-of-pocket fees,

costs and expenses incurred in connection with any filing required hereunder, including without limitation, any financing statements pursuant to the UCC, continuation statements, partial releases and/or termination statements related thereto or any expenses of any searches reasonably required by the Agent. The Debtors shall also pay all other claims and charges which in the reasonable opinion of the Agent and/or Secured Parties might prejudice, imperil or otherwise affect the Collateral or the Security Interest therein. The Debtors will also, upon demand, pay to the Agent and/or Secured Parties the amount of any and all reasonable expenses, including the reasonable fees and expenses of its counsel and of any experts and agents, which the Agent and/or Secured Parties may incur in connection with (i) the enforcement of this Agreement, (ii) the custody or preservation of, or the sale of, collection from, or other realization upon, any of the Collateral, or (iii) the exercise or enforcement of any of the rights of the Secured Parties under the Debentures. Until so paid, any fees payable hereunder shall be added to the principal amount of the Debentures and shall bear interest at the Default Rate.

10. Responsibility for Collateral. Each Debtor assumes all liabilities and

responsibility in connection with all Collateral, and the obligations of such

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Debtor hereunder, under the Debentures or under the IP Security Agreement shall in no way be affected or diminished by reason of the loss, destruction, damage or theft of any of the Collateral or its unavailability for any reason.

11. Security Interest Absolute. All rights of the Secured Parties and all

Obligations of the Debtors hereunder, shall be absolute and unconditional, irrespective of: (a) any lack of validity or enforceability of this Agreement, the Debentures, IP Security Agreement or any agreement entered into in connection with the foregoing, or any portion hereof or thereof; (b) any change in the time, manner or place of payment or performance of, or in any other term of, all or any of the Obligations, or any other amendment or waiver of or any consent to any departure from the Debentures or the IP Security Agreement or any other agreement entered into in connection with the foregoing; (c) any exchange, release or nonperfection of any of the Collateral, or any release or amendment or waiver of or consent to departure from any other collateral for, or any

guaranty, or any other security, for all or any of the Obligations; (d) any action by the Secured Parties to obtain, adjust, settle and cancel in its sole discretion any insurance claims or matters made or arising in connection with the Collateral; or (e) any other circumstance which might otherwise constitute any legal or equitable defense available to the Debtors, or a discharge of all or any part of the Security Interest granted hereby. Until the Obligations shall have been paid and performed in full, the rights of the Secured Parties shall continue even if the Obligations are barred for any reason, including, without limitation, the running of the statute of limitations or bankruptcy. Each Debtor expressly waives presentment, protest, notice of protest, demand, notice of nonpayment and demand for performance. In the event that at any time any transfer of any Collateral or any payment received by the Secured Parties hereunder shall be deemed by final order of a court of competent jurisdiction to have been a voidable preference or fraudulent conveyance under the bankruptcy or insolvency laws of the United States, or shall be deemed to be otherwise due to any party other than the Secured Parties, then, in any such event, the Debtors' obligations hereunder shall survive cancellation of this Agreement, and shall not be discharged or satisfied by any prior payment thereof and/or cancellation of this Agreement, but shall remain a valid and binding obligation enforceable in accordance with the terms and provisions hereof. Each Debtor waives all right to require the Secured Parties to proceed against any other person or to apply any Collateral which the Secured Parties may hold at any time, or to marshal assets, or to pursue any other remedy. Each Debtor waives any defense arising by reason of the application of the statute of limitations to any obligation secured hereby.

12. Term of Agreement. This Agreement and the Security Interest shall

 terminate on the date on which all payments under the Debentures have been made in full or otherwise converted pursuant to the terms thereof and all other Obligations have been paid or discharged. Upon such termination, the Secured Parties, at the request and at the expense of the Debtors, will join in executing any termination statement with respect to any financing statement executed and filed pursuant to this Agreement.

13. Power of Attorney; Further Assurances. (a) Each Debtor authorizes the

 Secured Parties, and does hereby make, constitute and appoint it, and its respective officers, agents, successors or assigns with full power of substitution, as the Debtors' true and lawful attorney-in-fact, with power, in its own name or in the name of the Debtors, to, after the occurrence and during the continuance of an Event of Default, (i) endorse any notes, checks, drafts,

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money orders, or other instruments of payment (including payments payable under or in respect of any policy of insurance) in respect of the Collateral that may come into possession of the Secured Parties; (ii) to sign and endorse any financing statement pursuant to the UCC or any invoice, freight or express bill, bill of lading, storage or warehouse receipts, drafts against debtors, assignments, verifications and notices in connection with accounts, and other documents relating to the Collateral; (iii) to pay or discharge taxes, liens, security interests or other encumbrances at any time levied or placed on or threatened against the Collateral; (iv) to demand, collect, receipt for, compromise, settle and sue for monies due in respect of the Collateral; and (v) generally, to do, at the option of the Secured Parties, and at the Debtors' expense, at any time, or from time to time, all acts and things which the Secured Parties deems necessary to protect, preserve and realize upon the Collateral and the Security Interest granted therein in order to effect the intent of this Agreement, the Debentures and the IP Security Agreement all as fully and effectually as the Debtors might or could do; and each Debtor hereby ratifies all that said attorney shall lawfully do or cause to be done by virtue

hereof. This power of attorney is coupled with an interest and shall be irrevocable for the term of this Agreement and thereafter as long as any of the Obligations shall be outstanding.

(b) On a continuing basis, each Debtor will make, execute, acknowledge, deliver, file and record, as the case may be, with the proper filing and recording agencies in any jurisdiction, including, without limitation, the jurisdictions indicated on Schedule B, attached hereto, all such instruments, ----- and take all such action as may reasonably be deemed necessary or advisable, or as reasonably requested by the Secured Parties, to perfect the Security Interest granted hereunder and otherwise to carry out the intent and purposes of this Agreement, or for assuring and confirming to the Secured Parties the grant or perfection of a first priority security interest in all the Collateral under the UCC.

(c) Each Debtor hereby irrevocably appoints the Secured Parties as such Debtor's attorney-in-fact, with full authority in the place and stead of such Debtor and in the name of such Debtor, from time to time in the Secured Parties' discretion, to take any action and to execute any instrument which the Secured Parties may deem necessary or advisable to accomplish the purposes of this Agreement, including the filing, in its sole discretion, of one or more financing or continuation statements and amendments thereto, relative to any of the Collateral without the signature of such Debtor where permitted by law.

14. Agent.

(a) Actions The Agent shall at all times act upon and in accordance with -----
written instructions received from a Majority-in-Interest (as defined in Section 17) time to time. The Agent shall be deemed to be authorized on behalf of each Secured Party to act on behalf of such Secured Party under this Agreement and the IP Security Agreement and, in the absence of written instructions from a Majority-in-Interest (with respect to which the Agent agrees that it will, subject to the last two sentences of this Section, comply, except as otherwise advised by counsel), to exercise such powers hereunder and thereunder as are specifically delegated to or required of the Agent by the terms hereof and thereof, together with such powers as may be reasonably incidental thereto. The Agent shall have no duty to ascertain or inquire as to the performance or observance of any of the terms of this Agreement or the IP Security Agreement by the Debtors. By accepting their Debentures each Secured Party shall be deemed to

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have agreed to indemnify the Agent (which agreement shall survive any termination of such Secured Party's percentage), from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements of any kind or nature whatsoever which may at any time be imposed on, incurred by, or asserted against the Agent in any way relating to or arising out of this Agreement, the Debentures and the IP Security Agreement, including the reimbursement of the Agent for all out-of-pocket expenses (including attorneys' fees) incurred by the Agent hereunder or in connection herewith or in enforcing the Obligations of the Debtors under this Agreement, the Debentures or the IP Security Agreement, in all cases as to which the Agent is not reimbursed by the Debtors; provided that no Secured Party shall -----

be liable for the payment of any portion of such liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements determined by a court of competent jurisdiction in a final proceeding to have resulted solely from the Agent's gross negligence or willful

misconduct. The Agent shall not be required to take any action hereunder, under the Debentures or under IP Security Agreement, or to prosecute or defend any suit in respect of this Agreement or under the Debentures or under IP Security Agreement, unless the Agent is indemnified to its reasonable satisfaction by the Secured Parties against loss, costs, liability and expense. If any indemnity in favor of the Agent shall become impaired, it may call for additional indemnity and cease to do the acts indemnified against until such additional indemnity is given.

(b) Exculpation. Neither the Agent nor any of its directors, officers,

partners, members, shareholders, employees or agents shall be liable to any Secured Party for any action taken or omitted to be taken by it under this Agreement, the Debentures or the IP Security Agreement, or in connection herewith or therewith, except for its own willful misconduct or gross negligence or be responsible for the consequences of any error in judgment. Neither the Agent nor any of its directors, officers, partners, members, shareholders, employees or agents has any fiduciary relationship with any Secured Party by virtue of this Agreement or the IP Security Agreement. The Agent shall not be responsible to any Secured Party for any recitals, statements, representations or warranties herein or in any certificate or other document delivered in connection herewith or for the authorization, execution, effectiveness, genuineness, validity, enforceability, perfection, collectibility, or sufficiency this Agreement, the Debentures or the IP Security Agreement, the financial condition of the Debtors or the condition or value of any of the Collateral, or be required to make any inquiry concerning either the performance or observance of any of the terms, provisions or conditions of this Agreement, the Debentures or the IP Security Agreement, the financial condition of the Debtors or the existence or possible existence of any default or event of default. The Agent shall be entitled to rely upon advice of counsel concerning legal matters and upon any notice, consent, certificate, statement or writing which it believes to be genuine and to have presented by a proper person.

(c) Obligations Held by the Agent. The Agent shall have the same rights and

powers with respect to any Debentures held by it or any of its affiliates, as any Secured Party and may exercise the same as if it were not the Agent. Each of the Debtors and the Secured Parties hereby waives, and each successor to any Secured Party shall be deemed to waive, any right to disqualify any Secured Party from serving as the Agent or any claim against that Secured Party for serving as Agent.

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(d) Copies, etc. The Agent shall give prompt notice to each Secured Party

of each notice or request required or permitted to be given to the Agent by the Debtors pursuant to the terms of this Agreement. The Agent will distribute to each Secured Party each instrument and other agreement received for its account and copies of all other communications received by the Agent from a Debtor for distribution to the Secured Parties by the Agent in accordance with the terms of this Agreement. Notwithstanding anything herein contained to the contrary, all notices to and communications with the Debtors under this Agreement shall be effected by the Secured Parties through the Agent.

(e) Resignation of Agent. The Agent may resign as such at any time upon at

least thirty (30) days' prior notice to the Debtors and all the Secured Parties, such resignation not to be effective until a successor Agent is in place. If the Agent at any time shall resign, a Majority-in-Interest may jointly appoint another Secured Party as a successor Agent which shall thereupon become the Agent hereunder. Upon the acceptance of any appointment as Agent hereunder by a

successor Agent, such successor Agent shall be entitled to receive from the retiring Agent such documents of transfer and assignment as such successor Agent may reasonably request, and shall thereupon succeed to and become vested with all rights, powers, privileges, and duties of the retiring Agent, and the retiring Agent shall be discharged from its duties and obligations under this Agreement.

(f) Replacement of Agent. A Majority-in-Interest may at any time and for

any reason replace the Agent with a successor Agent jointly selected by them, upon at least ten days written notice to the Debtors and the other Secured Parties. Upon the acceptance of any appointment as Agent hereunder by a successor Agent, such successor Agent shall be entitled to receive from the terminated Agent such documents of transfer and assignment as such successor Agent may reasonably request, and shall thereupon succeed to and become vested with all rights, powers, privileges, and duties of the retiring Agent, and the terminated Agent shall be discharged from its duties and obligations under this Agreement.

15. Notices. All notices, requests, demands and other communications

hereunder shall be in writing, with copies to all the other parties hereto, and shall be deemed to have been duly given when (i) if delivered by hand, upon receipt, (ii) if sent by facsimile, upon receipt of proof of sending thereof, (iii) if sent by nationally recognized overnight delivery service (receipt requested), the next business day or (iv) if mailed by first-class registered or certified mail, return receipt requested, postage prepaid, four days after posting in the U.S. mails, in each case if delivered to the following addresses:

If to the Debtors: Electric Fuel Corporation
632 Broadway, Suite 301
New York, NY 10012
Facsimile No.: (212) 529-5800
Attn: Chief Financial Officer and General Counsel

With a copy to: Electric Fuel (E.F.L.) Ltd.
Western Industrial Zone
Beit Shemesh 99000, Israel
Facsimile No.: 011-972-2-990-6688
Attn.: Chief Financial Officer and General Counsel

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If to the Secured Parties: To the address set forth under such Secured Parties' name on the signature pages hereto.

16. Other Security. To the extent that the Obligations are now or hereafter

secured by property other than the Collateral or by the guarantee, endorsement or property of any other person, firm, corporation or other entity, then the Secured Parties shall have the right, in its sole discretion, to pursue, relinquish, subordinate, modify or take any other action with respect thereto, without in any way modifying or affecting any of the Secured Parties' rights and remedies hereunder.

17. Actions by Secured Parties. Any action required or permitted hereunder

to be taken by or on behalf of the Secured Parties shall, for such action to be valid, require the approval of the Majority-in-Interest prior to the taking of such action. If the consent, approval or disapproval of the Secured Parties is

required or permitted pursuant to this Agreement, such consent, approval or disapproval shall only be valid if given by the Majority-in-Interest. "MAJORITY-IN-INTEREST" means the Secured Party or Secured Parties (as the case may be) holding in excess of a majority of the outstanding aggregate principal amount under the Debentures, determined on a cumulative basis.

18. Miscellaneous.

(a) No course of dealing between the Debtors and the Secured Parties, nor any failure to exercise, nor any delay in exercising, on the part of the Secured Parties, any right, power or privilege hereunder, under the Debentures or under the IP Security Agreement shall operate as a waiver thereof; nor shall any single or partial exercise of any right, power or privilege hereunder or thereunder preclude any other or further exercise thereof or the exercise of any other right, power or privilege.

(b) All of the rights and remedies of the Secured Parties with respect to the Collateral, whether established hereby, by the Debentures, by the IP Security Agreement or by any other agreements, instruments or documents or by law shall be cumulative and may be exercised singly or concurrently.

(c) This Agreement constitutes the entire agreement of the parties with respect to the subject matter hereof and is intended to supersede all prior negotiations, understandings and agreements with respect thereto. Except as specifically set forth in this Agreement, no provision of this Agreement may be modified or amended except by a written agreement signed by the parties hereto.

(d) In the event that any provision of this Agreement is held to be invalid, prohibited or unenforceable in any jurisdiction for any reason, unless such provision is narrowed by judicial construction, this Agreement shall, as to such jurisdiction, be construed as if such invalid, prohibited or unenforceable provision had been more narrowly drawn so as not to be invalid, prohibited or

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unenforceable. If, notwithstanding the foregoing, any provision of this Agreement is held to be invalid, prohibited or unenforceable in any jurisdiction, such provision, as to such jurisdiction, shall be ineffective to the extent of such invalidity, prohibition or unenforceability without invalidating the remaining portion of such provision or the other provisions of this Agreement and without affecting the validity or enforceability of such provision or the other provisions of this Agreement in any other jurisdiction.

(e) No waiver of any breach or default or any right under this Agreement shall be considered valid unless in writing and signed by the party giving such waiver, and no such waiver shall be deemed a waiver of any subsequent breach or default or right, whether of the same or similar nature or otherwise.

(f) This Agreement shall be binding upon and inure to the benefit of each party hereto and its successors and assigns.

(g) Each party shall take such further action and execute and deliver such further documents as may be necessary or appropriate in order to carry out the provisions and purposes of this Agreement.

(h) This Agreement shall be construed in accordance with the laws of the State of New York, except to the extent the validity, perfection or enforcement of a security interest hereunder in respect of any particular Collateral which are governed by a jurisdiction other than the State of New York in which case such law shall govern. Each of the parties hereto irrevocably submits to the exclusive jurisdiction of any New York State or United States Federal court

sitting in New York county over any action or proceeding arising out of or relating to this Agreement, and the parties hereto hereby irrevocably agree that all claims in respect of such action or proceeding may be heard and determined in such New York State or Federal court. The parties hereto agree that a final judgment in any such action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any other manner provided by law. The parties hereto further waive any objection to venue in the State of New York and any objection to an action or proceeding in the State of New York on the basis of forum non convenient. If either party shall commence an action or a proceeding to enforce any provisions of this Agreement, then the prevailing party in such action or proceeding shall be reimbursed by the other party for its attorney's fees and other costs and expenses incurred with the investigation, preparation and prosecution of such action or proceeding.

(i) EACH PARTY HERETO HEREBY AGREES TO WAIVE ITS RESPECTIVE RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL ENCOMPASSING OF ANY DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS AGREEMENT, INCLUDING WITHOUT LIMITATION CONTRACT CLAIMS, TORT CLAIMS, BREACH OF DUTY CLAIMS AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. EACH PARTY HERETO ACKNOWLEDGES THAT THIS WAIVER IS A MATERIAL INDUCEMENT FOR EACH PARTY TO ENTER INTO A BUSINESS RELATIONSHIP, THAT EACH PARTY HAS ALREADY RELIED ON THIS WAIVER IN ENTERING INTO THIS AGREEMENT AND THAT EACH PARTY WILL CONTINUE TO RELY

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ON THIS WAIVER IN THEIR RELATED FUTURE DEALINGS. EACH PARTY FURTHER WARRANTS AND REPRESENTS THAT IT HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT SUCH PARTY KNOWINGLY AND VOLUNTARILY WAIVES ITS RIGHTS TO A JURY TRIAL FOLLOWING SUCH CONSULTATION. THIS WAIVER IS IRREVOCABLE, MEANING THAT, NOTWITHSTANDING ANYTHING HEREIN TO THE CONTRARY, IT MAY NOT BE MODIFIED EITHER ORALLY OR IN WRITING, AND THIS WAIVER SHALL APPLY TO ANY SUBSEQUENT AMENDMENTS, RENEWALS AND SUPPLEMENTS OR MODIFICATIONS TO THIS AGREEMENT. IN THE EVENT OF A LITIGATION, THIS AGREEMENT MAY BE FILED AS A WRITTEN CONSENT TO A TRIAL BY THE COURT.

(j) This Agreement may be executed in any number of counterparts, each of which when so executed shall be deemed to be an original and, all of which taken together shall constitute one and the same Agreement. In the event that any signature is delivered by facsimile transmission, such signature shall create a valid binding obligation of the party executing (or on whose behalf such signature is executed) the same with the same force and effect as if such facsimile signature were the original thereof.

* * * * *

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IN WITNESS WHEREOF, the parties hereto have caused this Security Agreement to be duly executed on the day and year first above written.

ELECTRIC FUEL CORPORATION

By: _____
Name:
Title:

ELECTRIC FUEL TRANSPORTATION CORP.

By: _____
Name:
Title:

I.E.S. DEFENSE SERVICES, INC.

By: _____
Name:
Title:

IES INTERACTIVE TRAINING, INC.

By: _____
Name:
Title:

ELECTRIC FUEL GMBH

By: _____
Name:
Title:

SUMMIT TRAINING INTERNATIONAL, INC.

By: _____
Name:
Title:

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ELECTRIC FUEL UK LTD.

By: _____
Name:
Title:

ELECTRIC FUEL B.V.

By: _____
Name:
Title:

INSTANT POWER CORPORATION

By: _____
Name:
Title:

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IN WITNESS WHEREOF, the parties hereto have caused this Security Agreement to be duly executed on the day and year first above written.

ZLP MASTER TECHNOLOGY FUND, LTD.

By:_____

Name:

Title:

Address for Notice:

45 Broadway - 28th Floor

New York, NY 10006

Facsimile No.: ()

Attn:

With a copy to:

Bryan Cave LLP

1290 Avenue of the Americas

New York, NY 10104

Facsimile No.: (212) 541-4630 and (212) 541-1432

Attn: Eric L. Cohen, Esq.

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IN WITNESS WHEREOF, the parties hereto have caused this Security Agreement to be duly executed on the day and year first above written.

SMITHFIELD FIDUCIARY LLC

By:_____

Name:

Title:

Address for Notice:

c/o Highbridge Capital Management, LLC

9 West 57th Street, 27th Floor

New York, New York 10019

Attention: Ari J. Storch / Adam J. Chill

Facsimile: 212-751-0755

Telephone: 212-287-4720

With a copy to:

Bryan Cave LLP

1290 Avenue of the Americas

New York, NY 10104

Facsimile No.: (212) 541-4630 and (212) 541-1432

Attn: Eric L. Cohen, Esq.

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IN WITNESS WHEREOF, the parties hereto have caused this Security Agreement to be duly executed on the day and year first above written.

VERTICAL VENTURES INVESTMENTS, LLC

By: _____
Name:
Title:

Address for Notice:

c/o Vertical Ventures, LLC
900 Third Avenue, 26th Floor
New York, NY 10022
Facsimile No.: (646) 274-1728
Attn: Joshua Silverman

With a copy to:

Bryan Cave LLP
1290 Avenue of the Americas
New York, NY 10104
Facsimile No.: (212) 541-4630 and (212) 541-1432
Attn: Eric L. Cohen, Esq.

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Schedule A

Principal Place of Business of the Debtors:

Locations Where Collateral is Located or Stored:

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Schedule B

Jurisdictions:

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Schedule C

Name/Address of Subsidiary	Jurisdiction of Incorporation	Class of Securities	No. of Shares Outstanding	No. of Pledged Shares

<S>

<C>

<C>

<C>

<C>

I.E.S. Defense Services, Inc.				

IES Interactive Training, Inc.				

Electric Fuel GmbH				

Summit Training International, Inc.				

Electric Fuel
UK Ltd.

M.D.T. Protective
Services Ltd.

Electric Fuel Ltd.

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Exhibit 4.5

INTELLECTUAL PROPERTY SECURITY AGREEMENT

INTELLECTUAL PROPERTY SECURITY AGREEMENT, dated as of December 31, 2002, between Electric Fuel Corporation, a Delaware corporation (the "PARENT"), Electric Fuel Transportation Corp., a Delaware corporation ("EFT"), Electric Fuel B.V., a Netherlands corporation ("EF-BV"), Instant Power Corporation, a Delaware corporation ("IPC"), I.E.S. Defense Services, Inc., a Delaware corporation ("IDS"), IES Interactive Training, Inc. ("IES"), Electric Fuel GmbH, a German corporation ("EF-G"), Summit Training International, Inc., a Delaware corporation ("STI"), Electric Fuel UK Ltd., a British corporation ("EF-UK") (each of EFT, EF-BV, IPC, IDS, IES, EF-G, STI and EF-UK, a "SUBSIDIARY" and, together with Parent, the "DEBTORS") and the investors signatory hereto (each investor including their respective successors, endorsees, transferees and assigns, a "SECURED PARTY", and collectively, the "SECURED PARTIES").

W I T N E S S E T H:

WHEREAS, pursuant to the Securities Purchase Agreement, dated the date hereof between the Parent and the Secured Parties (the "PURCHASE AGREEMENT"), the Secured Parties have agreed to extend certain loans to the Parent which shall be evidenced by the issuance to the Secured Parties of Secured Convertible Debentures, due June 30, 2005 (the "DEBENTURES"); and

WHEREAS, in order to induce the Secured Parties to enter into the Purchase Agreement, the Debtors have agreed to execute and deliver to the Secured Parties this Agreement for the benefit of the Secured Parties and a separate agreement granting to them a first priority security interest in certain intangible property of the Debtors (the "SECURITY AGREEMENT") to secure the prompt payment, performance and discharge in full of all of the Debtors' obligations under this Agreement, the Debentures and the Security Agreement.

NOW, THEREFORE, in consideration of the agreements herein contained and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto hereby agree as follows:

1. Certain Definitions. As used in this Agreement, the following terms

shall have the meanings set forth in this Section 1. Terms used but not otherwise defined in this Agreement that are defined in Article 9 of the UCC (such as "GENERAL INTANGIBLES" and "PROCEEDS") shall have the respective meanings given such terms in Article 9 of the UCC.

(a) "AGENT" means ZLP Master Technology Fund as agent for each of the Secured Parties pursuant to this Agreement and the Security Agreement, or such other Person as shall have been subsequently appointed as a successor agent pursuant to this Agreement.

(b) "COLLATERAL" means all of the Debtors' right, title and interest in and to all of Trademarks, Patents, Copyrights, domain names and other general intangible property of the Debtors, all Debtors' trade secrets, Debtors'

intellectual property rights in Debtors' computer software and Debtors' computer software products, design rights which may be available, owned or licensed to

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the Debtors, all income, royalties, damages and payments now or hereafter due and/or payable under any of the foregoing or with respect to any of the foregoing Debtors' rights to proceeds arising from any and all claims for damages by way of past, present and future infringement of any Collateral with the right but not the obligation to sue on behalf of and collect such damages for said use or infringement of the Copyrights, Patents or Trademarks, and Debtors' rights with respect to licenses granted by Debtors' to third parties or licensed to Debtors to use any of the Copyrights, domain names, Patents or Trademarks, and all license fees and royalties due to the Debtors arising from such use to the extent permitted by such license or rights, all of which are now or hereafter existing, created, acquired or held. The term "COLLATERAL" shall include all of the foregoing items, whether presently owned or existing or hereafter acquired or coming into existence, all of Debtors' additions and accessions thereto, all of Debtors' substitutions and replacements thereof, and all of Debtors' proceeds, products and accounts thereof, including without limitation all proceeds from the licensing or sale or other transfer of Collateral and of insurance covering the same and of any tort claims in connection therewith.

(c) "COPYRIGHTS" means any and all of Debtors' (i) copyrights in computer software owned by the Company, including any revisions and derivative works, whether registered or not and whether or not the same also constitutes a trade secret, now or hereafter existing, created, acquired or held, including, without limitation, those set forth on Exhibit A attached hereto and (ii)

copyrights, copyright applications, copyright registration and like protections in each work of authorship and any derivative work thereof, including computer programs, that is created by the Debtors, whether published or unpublished and whether or not the same also constitutes a trade secret, and all copyright licenses now or hereafter existing, created, acquired or held by the Debtors, including, without limitation, those registrations and applications set forth on Exhibit A attached hereto

(d) "OBLIGATIONS" means all of the Debtors' obligations under this Agreement, the Debentures and the Security Agreement, in each case, whether now or hereafter existing, voluntary or involuntary, direct or indirect, absolute or contingent, liquidated or unliquidated, whether or not jointly owed with others, and whether or not from time to time decreased or extinguished and later increased, created or incurred, and all or any portion of such obligations or liabilities that are paid, to the extent all or any part of such payment is avoided or recovered directly or indirectly from the Secured Parties as a preference, fraudulent transfer or otherwise as such obligations may be amended, supplemented, converted, extended or modified from time to time.

(e) "PATENTS" means all of the Debtors' patents, patent applications, patent licenses, letters patent and like protections of the United States or any other country, including, without limitation, improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same, all of which are now or hereafter existing, created, acquired or held and including, without limitation, those registrations and applications set forth on Exhibit B attached hereto and all goodwill associated with or symbolized by any

of the foregoing.

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(f) "TRADEMARKS" means any Debtor trademark or service mark right,

whether or not registered, Debtors' applications to register and registrations of the same and like protections, any trademark or service mark licenses and the entire goodwill of the business of the Debtors connected with or symbolized by such trademarks or service marks, including all renewals thereof all of which are now or hereafter existing, created, acquired or held, including, without limitation, those registrations and applications set forth on Exhibit C attached

hereto all goodwill associated with or symbolized by any of the foregoing.

(g) "UCC" means the Uniform Commercial Code and/or any other applicable law of each jurisdiction in which any Debtor is incorporated or organized (including, without limitation the State of Delaware) and any jurisdiction as to any Collateral located therein.

2. Grant of Security Interest. As an inducement for the Secured

Parties to enter into the Purchase Agreement and to secure the complete and timely payment, performance and discharge in full, as the case may be, of all of the Obligations, each of the Debtors hereby, unconditionally and irrevocably, pledges, grants and hypothecates to the Secured Parties, a continuing first priority security interest in, a first lien upon and a right of set-off against all of the Debtors' right, title and interest of whatsoever kind and nature in and to the Collateral (the "SECURITY INTEREST").

3. Representations, Warranties, Covenants and Agreements of the Debtors

jointly and severally represent and warrant to, and covenant and agree with, the Secured Parties as follows:

(a) Each Debtor has the requisite corporate power and authority to enter into this Agreement and otherwise to carry out its obligations thereunder. The execution, delivery and performance by each Debtor of this Agreement and the filings contemplated therein have been duly authorized by all necessary action on the part of such Debtor and no further action is required by such Debtor.

(b) Except for the Security Interest and as set forth in Schedule 3(b)

hereto, each Debtor is the sole owner of the Collateral (except for non-exclusive licenses granted by the Debtors in the ordinary course of business), free and clear of any liens, security interests or encumbrances, and is fully authorized to grant the Security Interest in and to pledge the Collateral. There is not on file in any governmental or regulatory authority, agency or recording office an effective financing statement, security agreement or transfer or any notice of any of the foregoing (other than those that have been filed in favor of the Secured Parties pursuant to this Agreement) covering or affecting any of the Collateral. So long as this Agreement shall be in effect, the Debtors shall not execute and shall not knowingly permit to be on file in any such office or agency any such financing statement or other document or instrument (except to the extent filed or recorded in favor of the Secured Parties pursuant to the terms of this Agreement).

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(c) Exhibit A sets forth a true and complete list of all Debtors'

registrations and applications for Copyrights in existence as of the date of this Agreement. Exhibit B sets forth a true and complete list of all Debtors'

registrations and applications for Patents that have been filed as of the date of this Agreement. Exhibit C sets forth a true and complete list of all

Debtors' registrations and applications for Trademarks filed as of the date of this Agreement. The Debtors shall, within ten (10) days of obtaining knowledge

thereof, advise the Secured Parties in writing of any change in the composition of the Collateral, including, without limitation, any subsequent ownership rights of the Debtors in or to any Copyrights, Patents or Trademarks.

(d) Each of the Patents, Trademarks and Copyrights is valid and enforceable, and no part of the Collateral has been judged invalid or unenforceable. No written claim has been received that any of the Patents, Trademarks or Copyrights or the Debtors' use of any Collateral violates the rights of any third party. There has been no adverse decision to the Debtors' claim of ownership rights in or exclusive rights to use the Collateral in any jurisdiction or to the Debtors' right to keep and maintain such Collateral in full force and effect, and there is no proceeding involving said rights pending or, to the best knowledge of the Debtors, threatened before any court, judicial body, administrative or regulatory agency, arbitrator or other governmental authority.

(e) Each Debtor shall at all times maintain its books of account and records relating to the Collateral at its principal place of business and may not relocate such books of account and records unless it delivers to the Secured Parties at least 30 days prior to such relocation (i) written notice of such relocation and the new location thereof (which must be within the United States) and (ii) evidence that appropriate financing statements and other necessary documents have been filed and recorded and other steps have been taken to perfect the Security Interest to create in favor of the Secured Parties a valid, perfected and continuing first priority liens in the Collateral. The principal place of business of the Debtors is located at the address set forth in Schedule

A hereto, and will not be moved without notice to each Secured Party.
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(f) This Agreement creates in favor of the Secured Parties a valid security interest in the Collateral, including the Collateral listed on the Exhibits hereto, securing the payment and satisfaction of the Obligations, and, upon making the filings described in the immediately following sentence, a perfected first priority security interest in such Collateral that is senior to all existing and hereinafter created security interests. Except for (x) the filing of this Agreement with the United States Patent and Trademark Office with respect to the Patents and Trademarks and the filing of this Agreement with the United States Copyrights Office with respect to the Copyrights, and (y) the filing of financing statements on Form UCC-1 under the UCC with the jurisdictions indicated in Schedule A, attached hereto, no authorization or

approval of or filing with or notice to any governmental authority or regulatory body is required either (i) for the grant by the Debtors of, or the effectiveness of, the Security Interest granted hereby or for the execution, delivery and performance of this Agreement by the Debtors or (ii) for the perfection of or exercise by the Secured Parties of its rights and remedies hereunder. The Debtors acknowledge and agree that a copy of this Agreement (or instruments executed and delivered pursuant hereto) will be filed and recorded

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with each of the United States Patent and Trademark Office and the United States Copyrights Office with respect to the Patents, Trademarks and Copyrights that are now or hereafter in existence.

(g) The Debtors acknowledge and agree that on the date of execution of this Agreement, the Secured Parties will: (i) file one or more financing statements under the UCC with respect to the Security Interest for filing with the jurisdictions indicated on Schedule A, attached hereto and in such other

jurisdictions the Secured Parties may deem necessary and (ii) one or more executed recordation sheets relating to the filing and recording of this

Agreement with each of the United States Patent and Trademark Office and the United States Copyrights Office with respect to the Patents, Trademarks and Copyrights that are now in existence.

(h) The execution, delivery and performance of this Agreement does not conflict with or cause a breach or default, or an event that with or without the passage of time or notice, shall constitute a breach or default, under any agreement to which the Debtors are a party or by which the Debtors are bound. No consent (including, without limitation, from stock holders or creditors of the Debtors) is required for the Debtors to enter into and perform their obligations hereunder.

(i) The Debtors shall at all times maintain the liens and Security Interest provided for hereunder as valid and perfected first priority liens and security interests in the Collateral in favor of each of the Secured Parties to ensure that such liens and Security Interest are and remain senior to all not existing and hereafter created security interests and liens. The Collateral will be kept free of all liens, security interest, claims and encumbrances whatsoever. Each Debtor hereby agrees to defend the same against any and all persons. Each Debtor shall safeguard and protect all Collateral for the account of the Secured Parties. At the request of the Agent and/or Secured Parties, the Debtors will sign and deliver to the Secured Parties at any time or from time to time one or more financing statements pursuant to the UCC in form reasonably satisfactory to the Secured Parties and will pay the cost of filing the same in all public offices wherever filing is, or is deemed by the Secured Parties to be, necessary or desirable to effect the rights and obligations provided for herein. Without limiting the generality of the foregoing, the Debtors shall pay all fees, taxes and other amounts necessary to maintain the Collateral and the Security Interest hereunder, and the Debtors shall obtain and furnish to the Secured Parties from time to time, upon demand, such releases and/or subordinations of claims and liens which may be required to maintain the priority of the Security Interest hereunder.

(j) The Debtors will not allow any Collateral to be abandoned, forfeited or dedicated to the public without the prior written consent of the Secured Parties. The Debtors will not transfer, pledge, hypothecate, encumber, license (except for non-exclusive licenses granted by the Debtors in the ordinary course of business), sell or otherwise dispose of any of the Collateral without the prior written consent of the Secured Parties.

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(k) Each Debtor shall, within ten (10) days of obtaining knowledge thereof, advise the Agent, in sufficient detail, of any substantial change in the Collateral, and of the occurrence of any event which would have a material adverse effect on the value of the Collateral or on the Secured Parties' security interest therein.

(l) The Debtors shall permit the Secured Parties and its representatives and agents upon reasonable prior notice to inspect the Collateral at any time during normal business hours, and to make copies of records pertaining to the Collateral as may be requested by the Secured Parties from time to time.

(m) Each Debtor will, at its own expense, take all steps reasonably necessary to diligently pursue and seek to preserve, enforce and collect any rights, claims, causes of action and accounts receivable in respect of the Collateral.

(n) Each Debtor shall promptly notify the Agent in sufficient detail upon becoming aware of any attachment, garnishment, execution or other legal process levied against any Collateral and of any other information received by the Debtors that may materially affect the value of the Collateral, the Security

Interest or the rights and remedies of the Secured Parties hereunder.

(o) Each Debtor shall not use or permit any Collateral to be used unlawfully or in violation of any provision of this Agreement or any applicable statute, regulation or ordinance or any policy of insurance covering the Collateral where violation is reasonably likely to have a material adverse effect on the Secured Parties' rights in the Collateral or Secured Parties' ability to foreclose on the Collateral.

(p) The Debtors shall not grant to any person or entity any rights or interests in or to any of the Collateral that are senior to, or pari passu with, the Secured Parties.

(q) Each Debtor shall notify the Agent of any change in such Debtor's name, identity, chief place of business, chief executive office or residence within 5 days of such change.

(r) All information heretofore, herein or hereafter supplied to the Secured Parties by or on behalf of the Debtors with respect to the Collateral is accurate and complete in all material respects as of the date furnished.

4. Defaults. The following events shall be "EVENTS OF DEFAULT": -----

(a) The occurrence of an Event of Default (as defined in the Debentures) under the Debentures;

(b) Any representation or warranty of the Debtors in this Agreement or in the Security Agreement shall prove to have been incorrect in any material respect when made; and

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(c) The failure by a Debtor to observe or perform any of its obligations hereunder or in the Security Agreement for ten (10) days after receipt by the Debtors of notice of such failure from the Secured Parties.

5. Duty To Hold In Trust. Upon the occurrence and during the -----

continuation of any Event of Default, the Debtors shall, upon receipt by it of any revenue, income or other sums subject to the Security Interest, whether payable pursuant to the Debentures or otherwise, or of any check, draft, note, trade acceptance or other instrument evidencing an obligation to pay any such sum, hold the same in trust for the Secured Parties and shall forthwith endorse and transfer any such sums or instruments, or both, to the Secured Parties for application to the satisfaction of the Obligations.

6. Rights and Remedies Upon Default. Upon the occurrence and during the -----

continuation of any Event of Default, the Agent (on behalf of, and for the benefit of itself and each of the Secured Parties) shall have the right to exercise all of the remedies conferred hereunder, under the Debentures and under the Security Agreement, and the Agent and the Secured Parties shall have all the rights and remedies of a secured party under the UCC. Without limitation, the Secured Parties shall have the following rights and powers:

(a) The Agent shall have the right to take possession of all tangible manifestations or embodiments of the Collateral and, for that purpose, enter, with the aid and assistance of any person, any premises where the Collateral, or any part thereof, is or may be placed and remove the same, and the Debtors shall assemble the Collateral and make it available to the Agent at places which the Agent shall reasonably select, whether at the Debtors' premises or elsewhere.

(b) The Agent shall have the right to operate the business of the Debtors using the Collateral and shall have the right to assign, sell, or otherwise dispose of and deliver all or any part of the Collateral, at public or private sale or otherwise, either with or without special conditions or stipulations, for cash or on credit or for future delivery, in such parcel or parcels and at such time or times and at such place or places, and upon such terms and conditions as the Agent may deem commercially reasonable, all without (except as shall be required by applicable statute and cannot be waived) advertisement or demand upon or notice to the Debtors or right of redemption of the Debtors, which are hereby expressly waived. Upon each such sale, assignment or other transfer of Collateral, the Agent may, unless prohibited by applicable law which cannot be waived, purchase all or any part of the Collateral being sold, free from and discharged of all trusts, claims, right of redemption and equities of the Debtors, which are hereby waived and released.

(c) The Agent may license or, to the same extent the Debtors is permitted by law and contract to do so, sublicense, whether on an exclusive or non-exclusive basis, any of the Collateral throughout the world for such period, on such conditions and in such manner as the Secured Parties shall, in its reasonable discretion, determine.

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(d) The Agent may (without assuming any obligations or liabilities thereunder), at any time, enforce (and shall have the exclusive right to enforce) against licensee or sublicensee all rights and remedies of the Debtors in, to and under any license agreement with respect to such Collateral, and take or refrain from taking any action thereunder.

(e) The Agent may, in order to implement the assignment, license, sale or other disposition of any of the Collateral pursuant to this Section, pursuant to the authority provided for in Section 12, execute and deliver on behalf of the Debtors one or more instruments of assignment of the Collateral in form suitable for filing, recording or registration in any jurisdictions as the Secured Parties may determine advisable.

(f) In the event that any Secured Party shall recover from the Debtors or the Collateral more than its pro rata share of the Obligations owed to all Secured Parties hereunder, whether by agreement, understanding or arrangement with the Debtors or any other Person, set off or other means, such Secured Party shall immediately deliver or pay over to the other Secured Parties their pro rata portion of any such recovery in the form received.

(g) Agent may, at any time or times that an Event of Default exists or has occurred and is continuing, (i) notify any or all account debtors that the Accounts have been assigned to Secured Parties and that Secured Parties have a security interest therein and Agent may direct any or all accounts debtors to make payment of Accounts directly to Secured Parties, (ii) extend the time of payment of, compromise, settle or adjust for cash, credit, return of merchandise or otherwise, and upon any terms or conditions, any and all Accounts or other obligations included in the Collateral and thereby discharge or release the account debtor or any other party or parties in any way liable for payment thereof without affecting any of the Obligations, (iii) demand, collect or enforce payment of any Accounts or such other obligations, but without any duty to do so, and Agent shall not be liable for its failure to collect or enforce the payment thereof nor for the negligence of its agents or attorneys with respect thereto and (iv) take whatever other action Agent may deem necessary or desirable for the protection of its interests. At any time that an Event of Default exists or has occurred and is continuing, at Agent's request, all invoices and statements sent to any account debtor shall state that the Accounts and such other obligations have been assigned to Secured Parties and are payable directly and only to Secured Parties and the Debtors shall deliver to Agent such originals of documents evidencing the sale and delivery of goods or the

performance of services giving rise to any Accounts as Agent may require.

7. Applications of Proceeds. The proceeds of any such sale, lease,

license or other disposition of the Collateral hereunder shall be applied (i) first, to the expenses of retaking, holding, storing, processing and preparing for sale, selling, and the like (including, without limitation, any taxes, fees and other costs incurred in connection therewith) of the Collateral, (ii) to the reasonable attorneys' fees and expenses incurred by the Agent and/or Secured Parties in enforcing its rights hereunder and in connection with collecting, storing and disposing of the Collateral, (iii) to satisfaction of the Obligations, and (iv) to the payment of any other amounts required by applicable

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law, after which the Secured Parties shall pay to the Debtors any surplus proceeds. If, upon the sale, license or other disposition of the Collateral, the proceeds thereof are insufficient to pay all amounts to which the Secured Parties are legally entitled, the Debtors will be liable for the deficiency, together with interest thereon, at the rate of 12% per annum or the lesser amount permitted by applicable law (the "DEFAULT RATE"), and the reasonable fees of any attorneys employed by the Agent and/or Secured Parties to collect such deficiency. To the extent permitted by applicable law, each Debtor waives all claims, damages and demands against the Secured Parties arising out of the repossession, removal, retention or sale of the Collateral, unless due to the gross negligence or willful misconduct of the Agent and/or Secured Parties.

8. Costs and Expenses. The Debtors agree to pay all out-of-pocket fees,

costs and expenses incurred in connection with any filing required hereunder, including, without limitation, any financing statements, continuation statements, partial releases and/or termination statements related thereto or any expenses of any searches reasonably required by the Agent. The Debtors shall also pay all other claims and charges which in the reasonable opinion of the Agent and/or Secured Parties might prejudice, imperil or otherwise affect the Collateral or the Security Interest therein. The Debtors will also, upon demand, pay to the Agent and/or Secured Parties the amount of any and all reasonable expenses, including the reasonable fees and expenses of its counsel and of any experts and agents, which the Agent and/or Secured Parties may incur in connection with (i) the enforcement of this Agreement, (ii) the custody or preservation of, or the sale of, collection from, or other realization upon, any of the Collateral, or (iii) the exercise or enforcement of any of the rights of the Secured Parties under the Debentures. Until so paid, any fees payable hereunder shall be added to the principal amount of the Debentures and shall bear interest at the Default Rate.

9. Responsibility for Collateral. Each Debtor assumes all liabilities and

responsibility in connection with all Collateral, and the obligations of such Debtor hereunder, under the Debentures or under the Security Agreement shall in no way be affected or diminished by reason of the loss, destruction, damage or theft of any of the Collateral or its unavailability for any reason.

10. Security Interest Absolute. All rights of the Secured Parties and all

Obligations of the Debtors hereunder, shall be absolute and unconditional, irrespective of: (a) any lack of validity or enforceability of this Agreement, the Debentures, the Security Agreement or any agreement entered into in connection with the foregoing, or any portion hereof or thereof; (b) any change in the time, manner or place of payment or performance of, or in any other term of, all or any of the Obligations, or any other amendment or waiver of or any consent to any departure from the Debentures, the Security Agreement or any other agreement entered into in connection with the foregoing; (c) any exchange,

release or nonperfection of any of the Collateral, or any release or amendment or waiver of or consent to departure from any other collateral for, or any guaranty, or any other security, for all or any of the Obligations; (d) any action by the Secured Parties to obtain, adjust, settle and cancel in its sole discretion any insurance claims or matters made or arising in connection with the Collateral; or (e) any other circumstance which might otherwise constitute any legal or equitable defense available to the Debtors, or a discharge of all

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or any part of the Security Interest granted hereby. Until the Obligations shall have been paid and performed in full, the rights of the Secured Parties shall continue even if the Obligations are barred for any reason, including, without limitation, the running of the statute of limitations or bankruptcy. Each Debtor expressly waives presentment, protest, notice of protest, demand, notice of nonpayment and demand for performance. In the event that at any time any transfer of any Collateral or any payment received by the Secured Parties hereunder shall be deemed by final order of a court of competent jurisdiction to have been a voidable preference or fraudulent conveyance under the bankruptcy or insolvency laws of the United States, or shall be deemed to be otherwise due to any party other than the Secured Parties, then, in any such event, the Debtors' obligations hereunder shall survive cancellation of this Agreement, and shall not be discharged or satisfied by any prior payment thereof and/or cancellation of this Agreement, but shall remain a valid and binding obligation enforceable in accordance with the terms and provisions hereof. Each Debtor waives all right to require the Secured Parties to proceed against any other person or to apply any Collateral which the Secured Parties may hold at any time, or to marshal assets, or to pursue any other remedy. Each Debtor waives any defense arising by reason of the application of the statute of limitations to any obligation secured hereby.

11. Term of Agreement. This Agreement and the Security Interest shall

terminate on the date on which all payments under the Debentures have been made in full or otherwise converted pursuant to the terms thereof and all other Obligations have been paid or discharged. Upon such termination, the Secured Parties, at the request and at the expense of the Debtors, will join in executing any termination statement with respect to any financing statement executed and filed pursuant to this Agreement.

12. Power of Attorney; Further Assurances. (a) Each Debtor authorizes the

Secured Parties, and does hereby make, constitute and appoint it, and its respective officers, agents, successors or assigns with full power of substitution, as the Debtors' true and lawful attorney-in-fact, with power, in its own name or in the name of the Debtors, to, after the occurrence and during the continuance of an Event of Default, (i) endorse any notes, checks, drafts, money orders, or other instruments of payment (including payments payable under or in respect of any policy of insurance) in respect of the Collateral that may come into possession of the Secured Parties; (ii) to sign and endorse any UCC financing statement or any invoice, freight or express bill, bill of lading, storage or warehouse receipts, drafts against debtors, assignments, verifications and notices in connection with accounts, and other documents relating to the Collateral; (iii) to pay or discharge taxes, liens, security interests or other encumbrances at any time levied or placed on or threatened against the Collateral; (iv) to demand, collect, receipt for, compromise, settle and sue for monies due in respect of the Collateral; and (v) generally, to do, at the option of the Secured Parties, and at the Debtors' expense, at any time, or from time to time, all acts and things which the Secured Parties deem necessary to protect, preserve and realize upon the Collateral and the Security Interest granted therein in order to effect the intent of this Agreement, the Debentures and the Security Agreement, all as fully and effectually as the Debtors might or could do; and each Debtor hereby ratifies all that said

attorney shall lawfully do or cause to be done by virtue hereof. This power of

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attorney is coupled with an interest and shall be irrevocable for the term of this Agreement and thereafter as long as any of the Obligations shall be outstanding.

(b) On a continuing basis, each Debtor will make, execute, acknowledge, deliver, file and record, as the case may be, with the proper filing and recording places in any jurisdiction, including, without limitation, the jurisdictions indicated on Schedule A, attached hereto, all such

instruments, including appropriate financing and continuation statements and collateral agreements and filings with the United States Patent and Trademark Office and the United States Copyrights Office, and take all such action as may reasonably be deemed necessary or advisable, or as reasonably requested by the Secured Parties, to perfect the Security Interest granted hereunder and otherwise to carry out the intent and purposes of this Agreement, or for assuring and confirming to the Secured Parties the grant or perfection of a first priority security interest in all the Collateral.

(c) Each Debtor hereby irrevocably appoints the Secured Parties as such Debtors' attorney-in-fact, with full authority in the place and stead of such Debtor and in the name of such Debtor, from time to time in the Secured Parties' discretion, to take any action and to execute any instrument which the Agent may deem necessary or advisable to accomplish the purposes of this Agreement, including:

(i) To modify, in its sole discretion, this Agreement without first obtaining the Debtors' approval of or signature to such modification by amending Exhibit A, Exhibit B and Exhibit C, hereof, as appropriate, to

include reference to any right, title or interest in any Copyrights, Patents or Trademarks acquired by the Debtors after the execution hereof or to delete any reference to any right, title or interest in any Copyrights, Patents or Trademarks in which the Debtors no longer has or claims any right, title or interest; and

(ii) To file, in its sole discretion, one or more financing or continuation statements and amendments thereto, relative to any of the Collateral without the signature of the Debtors where permitted by law.

13. Agent.

(a) Actions The Agent shall at all times act upon and in accordance with written instructions received from a Majority-in-Interest (as defined in Section 16) time to time. The Agent shall be deemed to be authorized on behalf of each Secured Party to act on behalf of such Secured Party under this Agreement and the Security Agreement and, in the absence of written instructions from a Majority-in-Interest (with respect to which the Agent agrees that it will, subject to the last two sentences of this Section, comply, except as otherwise advised by counsel), to exercise such powers hereunder and thereunder as are specifically delegated to or required of the Agent by the terms hereof and thereof, together with such powers as may be reasonably incidental thereto. The Agent shall have no duty to ascertain or inquire as to the performance or observance of any of the terms of this Agreement or Security Agreement by the Debtors. By accepting their Debentures, each Secured Party shall be deemed to

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have agreed to indemnify the Agent (which agreement shall survive any termination of such Secured Party's percentage), from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements of any kind or nature whatsoever which may at any time be imposed on, incurred by, or asserted against the Agent in any way relating to or arising out of this Agreement, the Debentures and the Security Agreement, including the reimbursement of the Agent for all out-of-pocket expenses (including attorneys' fees) incurred by the Agent hereunder or in connection herewith or in enforcing the Obligations of the Debtors under this Agreement, the Debentures or the Security Agreement, in all cases as to which the Agent is not reimbursed by the Debtors; provided that no Secured Party shall

be liable for the payment of any portion of such liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements determined by a court of competent jurisdiction in a final proceeding to have resulted solely from the Agent's gross negligence or willful misconduct. The Agent shall not be required to take any action hereunder, under the Debentures or under Security Agreement, or to prosecute or defend any suit in respect of this Agreement or under the Debentures or under the Security Agreement, unless the Agent is indemnified to its reasonable satisfaction by the Secured Parties against loss, costs, liability and expense. If any indemnity in favor of the Agent shall become impaired, it may call for additional indemnity and cease to do the acts indemnified against until such additional indemnity is given.

(b) Exculpation. Neither the Agent nor any of its directors,

officers, partners, members, shareholders, employees or agents shall be liable to any Secured Party for any action taken or omitted to be taken by it under this Agreement, the Debentures or the Security Agreement, or in connection herewith or therewith, except for its own willful misconduct or gross negligence or be responsible for the consequences of any error in judgment. Neither the Agent nor any of its directors, officers, partners, members, shareholders, employees or agents has any fiduciary relationship with any Secured Party by virtue of this Agreement or the Security Agreement. The Agent shall not be responsible to any Secured Party for any recitals, statements, representations or warranties herein or in any certificate or other document delivered in connection herewith or for the authorization, execution, effectiveness, genuineness, validity, enforceability, perfection, collectibility, or sufficiency this Agreement, the Debentures or the Security Agreement, the financial condition of the Debtors or the condition or value of any of the Collateral, or be required to make any inquiry concerning either the performance or observance of any of the terms, provisions or conditions of this Agreement, the Debentures or the Security Agreement, the financial condition of the Debtors or the existence or possible existence of any default or event of default. The Agent shall be entitled to rely upon advice of counsel concerning legal matters and upon any notice, consent, certificate, statement or writing which it believes to be genuine and to have presented by a proper person.

(c) Obligations Held by the Agent. The Agent shall have the same

rights and powers with respect to any Debentures held by it or any of its affiliates, as any Secured Party and may exercise the same as if it were not the Agent. Each of the Debtors and the Secured Parties hereby waives, and each successor to any Secured Party shall be deemed to waive, any right to disqualify

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any Secured Party from serving as the Agent or any claim against that Secured Party for serving as Agent.

(d) Copies, etc. The Agent shall give prompt notice to each Secured

 Party of each notice or request required or permitted to be given to the Agent by the Debtors pursuant to the terms of this Agreement. The Agent will distribute to each Secured Party each instrument and other agreement received for its account and copies of all other communications received by the Agent from a Debtor for distribution to the Secured Parties by the Agent in accordance with the terms of this Agreement. Notwithstanding anything herein contained to the contrary, all notices to and communications with the Debtors under this Agreement shall be effected by the Secured Parties through the Agent.

(e) Resignation of Agent. The Agent may resign as such at any time

upon at least thirty (30) days' prior notice to the Debtors and all the Secured Parties, such resignation not to be effective until a successor Agent is in place. If the Agent at any time shall resign, a Majority-in-Interest may jointly appoint another Secured Party as a successor Agent which shall thereupon become the Agent hereunder. Upon the acceptance of any appointment as Agent hereunder by a successor Agent, such successor Agent shall be entitled to receive from the retiring Agent such documents of transfer and assignment as such successor Agent may reasonably request, and shall thereupon succeed to and become vested with all rights, powers, privileges, and duties of the retiring Agent, and the retiring Agent shall be discharged from its duties and obligations under this Agreement.

(f) Replacement of Agent. A Majority-in-Interest may at any time and

for any reason replace the Agent with a successor Agent jointly selected by them, upon at least ten days written notice to the Debtors and the other Secured Parties. Upon the acceptance of any appointment as Agent hereunder by a successor Agent, such successor Agent shall be entitled to receive from the

terminated Agent such documents of transfer and assignment as such successor Agent may reasonably request, and shall thereupon succeed to and become vested with all rights, powers, privileges, and duties of the retiring Agent, and the terminated Agent shall be discharged from its duties and obligations under this Agreement.

14. Notices. All notices, requests, demands and other communications

hereunder shall be in writing, with copies to all the other parties hereto, and shall be deemed to have been duly given when (i) if delivered by hand, upon receipt, (ii) if sent by facsimile, upon receipt of proof of sending thereof, (iii) if sent by nationally recognized overnight delivery service (receipt requested), the next business day or (iv) if mailed by first-class registered or certified mail, return receipt requested, postage prepaid, four days after posting in the U.S. mails, in each case if delivered to the following addresses:

If to the Debtors: Electric Fuel Corporation
 632 Broadway, Suite 301
 New York, NY 10012
 Facsimile No.: (212) 529-5800
 Attn: Chief Financial Officer and General Counsel

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With a copy to: Electric Fuel (E.F.L.) Ltd.
 Western Industrial Zone
 Beit Shemesh 99000, Israel
 Facsimile No.: 011-972-2-990-6688
 Attn.: Chief Financial Officer and General Counsel

If to Secured Parties: To the address set forth under such Secured Parties'

name on the signature pages hereto.

15. Other Security. To the extent that the Obligations are now or hereafter

secured by property other than the Collateral or by the guarantee, endorsement or property of any other person, firm, corporation or other entity, then the Secured Parties shall have the right, in its sole discretion, to pursue, relinquish, subordinate, modify or take any other action with respect thereto, without in any way modifying or affecting any of the Secured Parties' rights and remedies hereunder.

16. Actions by Secured Parties. Any action required or permitted hereunder

to be taken by or on behalf of the Secured Parties shall, for such action to be valid, require the approval of the Majority-in-Interest prior to the taking of such action. If the consent, approval or disapproval of the Secured Parties is required or permitted pursuant to this Agreement, such consent, approval or disapproval shall only be valid if given by the Majority-in-Interest.

"MAJORITY-IN-INTEREST" means the Secured Party or Secured Parties (as the case may be) holding in excess of a majority of the outstanding aggregate principal amount under the Debentures, determined on a cumulative basis.

17. Miscellaneous. (a) No course of dealing between the Debtors and the

Secured Parties, nor any failure to exercise, nor any delay in exercising, on the part of the Secured Parties, any right, power or privilege hereunder, under the Debentures or under the Security Agreement shall operate as a waiver thereof; nor shall any single or partial exercise of any right, power or privilege hereunder or thereunder preclude any other or further exercise thereof or the exercise of any other right, power or privilege.

(b) All of the rights and remedies of the Secured Parties with respect to the Collateral, whether established hereby, by the Debentures, by the Security Agreement or by any other agreements, instruments or documents or by law shall be cumulative and may be exercised singly or concurrently.

(c) This Agreement constitutes the entire agreement of the parties with respect to the subject matter hereof and is intended to supersede all prior negotiations, understandings and agreements with respect thereto. Except as specifically set forth in this Agreement, no provision of this Agreement may be modified or amended except by a written agreement signed by the parties.

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(d) In the event that any provision of this Agreement is held to be invalid, prohibited or unenforceable in any jurisdiction for any reason, unless such provision is narrowed by judicial construction, this Agreement shall, as to such jurisdiction, be construed as if such invalid, prohibited or unenforceable provision had been more narrowly drawn so as not to be invalid, prohibited or unenforceable. If, notwithstanding the foregoing, any provision of this Agreement is held to be invalid, prohibited or unenforceable in any jurisdiction, such provision, as to such jurisdiction, shall be ineffective to the extent of such invalidity, prohibition or unenforceability without invalidating the remaining portion of such provision or the other provisions of this Agreement and without affecting the validity or enforceability of such provision or the other provisions of this Agreement in any other jurisdiction.

(e) No waiver of any breach or default or any right under this Agreement shall be considered valid unless in writing and signed by the party giving such waiver, and no such waiver shall be deemed a waiver of any subsequent breach or default or right, whether of the same or similar nature or otherwise.

(f) This Agreement shall be binding upon and inure to the benefit of each party hereto and its successors and assigns.

(g) Each party shall take such further action and execute and deliver such further documents as may be necessary or appropriate in order to carry out the provisions and purposes of this Agreement.

(h) This Agreement shall be construed in accordance with the laws of the State of New York, except to the extent the validity, perfection or enforcement of a security interest hereunder in respect of any particular Collateral which are governed by a jurisdiction other than the State of New York in which case such law shall govern. Each of the parties hereto irrevocably submits to the exclusive jurisdiction of any New York State or United States Federal court sitting in New York county over any action or proceeding arising out of or relating to this Agreement, and the parties hereto hereby irrevocably agree that all claims in respect of such action or proceeding may be heard and determined in such New York State or Federal court. The parties hereto agree that a final judgment in any such action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any other manner provided by law. The parties hereto further waive any objection to venue in the State of New York and any objection to an action or proceeding in the State of New York on the basis of forum non convenient. If either party shall commence an action or a proceeding to enforce any provisions of this Agreement, then the prevailing party in such action or proceeding shall be reimbursed by the other party for its attorney's fees and other costs and expenses incurred with the investigation, preparation and prosecution of such action or proceeding.

(i) EACH PARTY HERETO HEREBY AGREES TO WAIVE ITS RESPECTIVE RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL ENCOMPASSING OF ANY DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF

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THIS AGREEMENT, INCLUDING WITHOUT LIMITATION CONTRACT CLAIMS, TORT CLAIMS, BREACH OF DUTY CLAIMS AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. EACH PARTY HERETO ACKNOWLEDGES THAT THIS WAIVER IS A MATERIAL INDUCEMENT FOR EACH PARTY TO ENTER INTO A BUSINESS RELATIONSHIP, THAT EACH PARTY HAS ALREADY RELIED ON THIS WAIVER IN ENTERING INTO THIS AGREEMENT AND THAT EACH PARTY WILL CONTINUE TO RELY ON THIS WAIVER IN THEIR RELATED FUTURE DEALINGS. EACH PARTY FURTHER WARRANTS AND REPRESENTS THAT IT HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT SUCH PARTY KNOWINGLY AND VOLUNTARILY WAIVES ITS RIGHTS TO A JURY TRIAL FOLLOWING SUCH CONSULTATION. THIS WAIVER IS IRREVOCABLE, MEANING THAT, NOTWITHSTANDING ANYTHING HEREIN TO THE CONTRARY, IT MAY NOT BE MODIFIED EITHER ORALLY OR IN WRITING, AND THIS WAIVER SHALL APPLY TO ANY SUBSEQUENT AMENDMENTS, RENEWALS AND SUPPLEMENTS OR MODIFICATIONS TO THIS AGREEMENT. IN THE EVENT OF A LITIGATION, THIS AGREEMENT MAY BE FILED AS A WRITTEN CONSENT TO A TRIAL BY THE COURT.

(j) This Agreement may be executed in any number of counterparts, each of which when so executed shall be deemed to be an original and, all of which taken together shall constitute one and the same Agreement. In the event that any signature is delivered by facsimile transmission, such signature shall create a valid binding obligation of the party executing (or on whose behalf such signature is executed) the same with the same force and effect as if such facsimile signature were the original thereof.

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IN WITNESS WHEREOF, the parties hereto have caused this Intellectual Property Security Agreement to be duly executed on the day and year first above written.

ELECTRIC FUEL CORPORATION

By: _____
Name:
Title:

ELECTRIC FUEL TRANSPORTATION
CORP.

By: _____
Name:
Title:

I.E.S. DEFENSE SERVICES, INC.

By: _____
Name:
Title:

IES INTERACTIVE TRAINING, INC.

By: _____
Name:
Title:

ELECTRIC FUEL GMBH

By: _____
Name:
Title:

SUMMIT TRAINING INTERNATIONAL, INC.

By: _____
Name:
Title:

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ELECTRIC FUEL UK LTD.

By: _____
Name:
Title:

ELECTRIC FUEL B.V.

By: _____
Name:
Title:

INSTANT POWER CORPORATION

By: _____
Name:
Title:

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IN WITNESS WHEREOF, the parties hereto have caused this Intellectual Property Security Agreement to be duly executed on the day and year first above written.

ZLP MASTER TECHNOLOGY FUND, LTD.

By: _____
 Name:
 Title:

Address for Notice:

45 Broadway - 28th Floor
 New York, NY 10006
 Facsimile No.: ()
 Attn:

With a copy to:

Bryan Cave LLP
 1290 Avenue of the Americas
 New York, NY 10104
 Facsimile No.: (212)541-4630 and (212)541-1432
 Attn: Eric L. Cohen, Esq.

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IN WITNESS WHEREOF, the parties hereto have caused this Intellectual Property Security Agreement to be duly executed on the day and year first above written.

SMITHFIELD FIDUCIARY LLC

By: _____
 Name:
 Title:

Address for Notice:

c/o Highbridge Capital Management, LLC
 9 West 57th Street, 27th Floor
 New York, New York 10019
 Attention: Ari J. Storch / Adam J. Chill
 Facsimile: 212-751-0755
 Telephone: 212-287-4720

With a copy to:

Bryan Cave LLP
 1290 Avenue of the Americas
 New York, NY 10104
 Facsimile No.: (212)541-4630 and (212)541-1432
 Attn: Eric L. Cohen, Esq.

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IN WITNESS WHEREOF, the parties hereto have caused this Intellectual Property Security Agreement to be duly executed on the day and year first above written.

VERTICAL VENTURES INVESTMENTS, LLC

By:_____

Name:

Title:

Address for Notice:

c/o Vertical Ventures, LLC
900 Third Avenue, 26th Floor
New York, NY 10022
Facsimile No.: (646) 274-1728
Attn: Joshua Silverman

With a copy to:

Bryan Cave LLP
1290 Avenue of the Americas
New York, NY 10104
Facsimile No.:(212)541-4630 and (212)541-1432
Attn: Eric L. Cohen, Esq.

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EXHIBIT A

COPYRIGHTS

Description	Registration Number	Registration Date

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EXHIBIT B

PATENTS

Description	Registration Number	Registration Date

<PAGE>

EXHIBIT C

TRADEMARKS

Description	Registration Number	Registration Date

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SCHEDULE A

Jurisdictions:

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<SEQUENCE>3
<FILENAME>doc12.txt
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Exhibit 10.68

SETTLEMENT AGREEMENT AND RELEASE

AGREEMENT ("Agreement") entered into this 31 day of December, 2002, by and between ELECTRIC FUEL CORPORATION, a Delaware corporation ("EFC") and ELECTRIC FUEL (E.F.L.) LTD., an Israeli corporation ("EFL" and, together with EFC, the "Company"), and YEHUDA HARATS, an individual residing at 45 HaShayarot Street, Jerusalem 92544, Israel (the "Employee").

W I T N E S S E T H :

WHEREAS, the Company and Employee are parties to an amended and restated employment agreement dated as of January 1, 2000 (the "Employment Agreement"); and

WHEREAS, the Company and the Employee, through their respective representatives, have held certain discussions concerning the facts and circumstances surrounding the termination of the Employee's employment with the Company; and

WHEREAS, both parties realize the uncertainty of litigation and the time-consuming and costly nature thereof; and

WHEREAS, the Company and the Employee desire to settle and resolve fully and finally any and all claims, potential claims, controversies or differences between them; and as more specifically set forth below and solely under the terms and conditions of this Settlement Agreement and Release; and

WHEREAS, the Company and the Employee desire to dismiss all the claims connected to or derived from Motion No. 2977/02 filed by the Employee in the labor court of Jerusalem and from the lawsuit filed by the Company against the Employee at the New-York State Supreme Court;

NOW, THEREFORE, in consideration of the premises and the mutual agreements hereinafter contained, the parties hereby agree as follows:

1. Employment Termination.

(a) The Company and Employee agree that the employment of the Employee shall be deemed to have ceased as of December 31, 2002.

(b) Subject to fulfillment of all the terms of this Agreement, the Employee represents and warrants that he has received full salary and any other compensation or benefit to which he is entitled from the Company.

(c) For the avoidance of doubt, it is agreed that the Employee will not be entitled to any other compensation or benefit for his employment with the Company.

(d) Until January 15, 2003, the Employee will return to the Company (and will not keep in his possession, recreate or deliver to anyone else) any and all

devices, Company property including without limitations, , palm pilot, cellular telephone sets, records, data, notes, correspondence developed or received by the Employee pursuant to Employee's employment with the Company or otherwise belonging to the Company.

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2. Payments.

(a) In place of whatever amounts to which the Employee may be entitled by law or by contract, and as full settlement of all mutual claims of the parties, the Employee agrees to accept a payment of US \$640,000 (which payments and benefits are in substitution for those required by any and all applicable laws of any and all jurisdictions and/or the terms of the Employment Agreement).

(b) US \$178,579 of the amount of US \$640,000 above is a return of a loan given by the Employee to the Company.

(c) US \$50,000 of the amount of US \$640,000 above is statutory severance payment. under the Israeli Severance Pay Law-1963 for the Employee's employment during a period of over 22 years (since July 15th, 1980).

(d) US \$411,421 of the amount of US \$640,000 above is special severance payment..

(e) Subject to fulfillment of all the terms of this Agreement, the above payment of US \$640,000 shall be paid according to the following schedule:

(i) Beginning in January 2nd 2003 and continuing through and including December 2005, the Company will pay the Employee, by direct deposit to the Employee's bank account at Bank Igud, Main Branch Jerusalem 013 Account No. 013433/65 (or as will be instructed by the employee from time to time, in writing), on a monthly basis, a total of 36 monthly payments of US \$7,777.77.

(ii) Prior to January 15, 2003, the Company shall transfer to the Employee the amount of US \$35,000, by direct deposit to the Employee's bank account provided above (or as will be instructed by the employee from time to time, in writing).

(iii) The Company shall pay the Employee, by direct deposit to the Employee's bank account provided above (or as will be instructed by the employee from time to time, in writing), an aggregate amount of \$325,000 in ten equal installments of US \$32,500. One such installment shall be due and payable by the last day of each of the months of September and December 2003, March, June, September and December 2004, and March, June, September and December 2005. The Employee shall be entitled to inform the Company by December 31, 2002, that he elects, at his sole discretion, to receive on or prior to December 31, 2002, the above amount of US \$325,000 or any part thereof by check paid in the United States that will be immediately endorsed by the Employee over to the order of EFC as a loan ("Loan"). The Loan shall be evidenced by a promissory note and shall be payable by the Company to the Employee according to the ten equal installments provided above. The Loan shall bear no interest.

(iv) Of the above specified amounts, the first US \$ 50,000 paid to the Employee will be considered as statutory severance payment under the Israeli Severance Pay Law-1963 for the Employee's employment referred to in sub section 2 (c). The next US \$ 178,579 will be considered as a return of the above loan given by the Employee to the Company referred to in Sub Section 2(b).

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(e) The Employee shall provide the Company with a receipt for each of the payments provided on Sub-Section (d) above.

(f) The Employee acknowledges that he is responsible for, and he does hereby indemnify the Company and its shareholders, directors, officers and employees from and against, the payment of any and all federal and state, including without limitations in Israel, income and like taxes, social security payments or any other withholding which may be or become payable with respect to any and all payment or any other consideration provided in this Agreement. With respect to any of the payments provided above, the Company shall deduct all statutory withholdings under any applicable law, including without limitations income tax and social security payments. If the company will deduct any sum of the above payments it will submit to the Employee all documentation concerning such deduction.

(g) In addition to the foregoing, the Company will also release the Employee's manager's insurance fund and study fund. The Company will take all steps reasonably necessary to release the above funds to the Employee, including but not limited to the prompt execution of any necessary paperwork. The Company declares that it does not have any rights whatsoever in the above funds and will not have any demands in regard with those funds.

3. Tax Refund.

The Employee presently has a petition for a tax refund relating to the execution of 131,655 options in February 9th, 2000 (the "Petition") pending before the Israeli tax authorities (the "Israeli IRS"). With respect to such Petition, the parties agree as follows:

(i) The Employee shall notify the Company within three business days of receipt of any communication from the Israeli IRS with respect to the Petition, including a copy of such communication, if in writing (including e-mail), or a written summary of such communication, if not in writing.

(ii) In the event that the Employee shall actually receive any tax refund, of any size, in connection with the Petition (an "Actual Refund"), he shall immediately notify the Company both orally and in writing of the amount of such Actual Refund., the parties agree that an amount of money equal to 10% of the amount of an Actual Refund (the "Refund Credit") shall be credited against the remaining amount that the Company shall owe the Employee at such time under Section 2(d)(iii) above. In the event that the Refund Credit shall be in excess of such remaining amount, the Employee shall immediately pay the Company any and all such excess Refund Credit.

(iii) In the event that the Employee shall receive any communication from the Israel IRS indicating that his petition for a tax refund has been granted, in whole or in part, but shall not yet have received an Actual Refund by the time any of the last two payments under Section 2(d)(iii) above shall have become due, the Company shall make such payments (up to the maximum amount of the Refund Credit) into an escrow account maintained by the law firm of Dr. J. Segev & Co. (the "Escrow") pending a final determination of the status of the Actual Refund.

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To the extent that, prior to or contemporaneously with the Company having received notice of an Actual Refund, the Company shall have paid amounts into Escrow, an amount of money equal to the amount paid into Escrow or the amount of the Refund Credit, whichever is the lesser, shall be released

from the Escrow and returned to the Company. Should the Israeli IRS reverse its determination and irrevocably decide that it will not give the Employee a refund, then these sums shall be released to the Employee.

(iv) The Company shall use its commercially reasonable best efforts to assist the Employee with obtaining a refund under the Petition (including but not limited to the prompt execution of any necessary paperwork), provided that such assistance is approved in advance by the Company's accountants.

4. Car.

The Employee shall be entitled to continue and hold the Company's car (VOLVO S-80, registration plate # 74-526-35) currently in his possession ("Car") as security for the Company payments under this agreement. The Employee shall return the Car to the Company by December 31, 2005. It is hereby agreed that the Employee may use the Car and he shall bear any and all expenses and taxes related to the Car. The Employee shall maintain the Car in good condition consistent with past practice and shall maintain an insurance policy on the Car at all times. To avoid doubt, holding the Car as security will not constitute any employment status or other relationship between the parties.

5. Standstill; Options.

(a) The Employee agrees that from the date hereof until September 30, 2003, neither he nor any member of his family shall, directly or indirectly, (i) offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, lend or otherwise transfer or dispose of, directly or indirectly, any of the shares of common stock or other securities of EFC ("Shares") nor (ii) enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of any of the Shares, whether any such transaction described in clause (i) or (ii) above is to be settled by delivery of Shares, in cash or otherwise.

(b) In consideration for this standstill agreement, the Company shall extend the term of the Employee's existing vested stock options to expire on September 30, 2005. Options granted to the employee in lieu of salary shall continue to have a ten-year limitation on their term.

(c) The parties acknowledge that any and all of Employee's stock options that shall not have vested by December 31, 2002, shall expire on that date.

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(d) Any violation of the provisions of Section 5(a) above shall automatically result in the immediate cancellation of all of the Employee's vested and outstanding options.

(e) The parties agree that the all the outstanding options and shares for which no share certificate has been issued in the name of the Employee on the date hereof are listed on EXHIBIT A attached hereto.

(f) Prior to September 30, 2003, the Company will comply with the terms of Section 16 of the Employment Agreement, provided that the Employee shall fulfill in a timely fashion all of his obligations under the terms of Section 16 of the Employment Agreement

6. Release of Claims.

(a) The Employee, subject to the release provided on Sub Section (b) below,

for himself, his heirs, executors, administrators, successors and assigns, hereby fully and unconditionally waives, releases, and forever discharges, the Company, its subsidiary companies, related and affiliated companies, predecessors, successors, assigns and its present and former directors, officers, agents and employees, from any and all suits, causes of action, and claims of any nature whatsoever, known or unknown, which the Employee may have against the Company and the other parties released hereby, which he and his heirs, executors, administrators, successors and assigns ever had, now have or hereafter can, shall or may have, for, upon, or by reason of any matter, cause or thing whatsoever from the beginning of the world to the day of the date of this release, including without limitation any and all claims in any way resulting from, arising out of or connected with his employment or its termination or pursuant to any Israeli common law, statute, regulation or other requirement, including without limitation (i) the Severance Payment Law of 1963, Annual Vacation Law of 1951, Protection of Wages Law of 1958, Sick Payment Law of 1976, Prior Notice for Dismissal and Resignation Law of 2001, recreation payment (Dmei Havra'a payment) and any and all claims under any collective bargaining agreement or extension thereof; (ii) any other compensation or consideration as a result of employment relations or end of employment relations including without limitation, Bituach Menaholim, Keren Hishtalmut, pension compensation, and/or any compensation and consideration resulting from such relations, or arising out of or connected with his position as a director of the Company and/or as a principal in the Company and/or connected with any act or vote of the Company's board of directors, whether by virtue of his position as a director, officer, employee or shareholder, all pursuant to any Israeli common law, statute, order, regulation or other requirement (including without limitation the Companies Ordinance [New Version] of 1983, the Companies Law of 1999, the Securities Law of 1968, the Torts Ordinance [New Version], each as amended from time to time, infliction of any tort, or breach of contract, whether actual or implied, or whether oral or written) including without limitation any United States federal, state or local common law, statute, regulation or other requirement (including without limitation the General Corporation Law of the State of Delaware, the United States Securities Act of 1933, and the United States Securities Exchange Act of 1934, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Americans with Disabilities Act, the fair employment practices laws of the state or states in which the Employee have been employed by the Company, each as amended from time to time, infliction of any tort, or breach of contract, whether actual or implied, or whether oral or written).

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(b) The Company, subject to the release provided on Sub Section (a) below, for itself, its subsidiary companies, related and affiliated companies, predecessors, successors, assigns and its present and former directors, officers, agents and employees, hereby fully and unconditionally waives, releases, and forever discharges, the Employee, his heirs, executors, administrators, successors and assigns, from any and all suits, causes of action, and claims of any nature whatsoever, known or unknown, which the Company may have against the Employee and the other parties released hereby, which it and its subsidiary companies, related and affiliated companies, predecessors, successors, assigns and its present and former directors, officers, agents and employees, ever had, now have or hereafter can, shall or may have, for, upon, or by reason of any matter, cause or thing whatsoever from the beginning of the world to the day of the date of this release, including without limitation any and all claims in any way resulting from, arising out of or connected with his employment or its termination or arising out of or connected with his position as a director of the Company and/or as a principal in the Company and/or connected with any act or vote of the Employee in the board of directors, and/or connected with any act of the Employee as a shareholder, all pursuant to any Israeli common law, statute, order, regulation or other requirement (including without limitation the Companies Ordinance [New Version] of 1983, the Companies Law of 1999, the Securities Law of 1968, the Torts Ordinance [New Version], each

as amended from time to time, infliction of any tort, or breach of contract, whether actual or implied, or whether oral or written) including without limitation any United States federal, state or local common law, statute, regulation or other requirement (including without limitation all Securities acts, laws and regulations, the General Corporation Law of the State of Delaware, the United States Securities Act of 1933, and the United States Securities Exchange Act of 1934, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Americans with Disabilities Act, the fair employment practices laws of the states in which the Employee have been employed by the Company, each as amended from time to time, infliction of any tort, or breach of contract, whether actual or implied, or whether oral or written).

(c) The Employee has carefully read this Agreement, knows its contents, and freely and voluntarily agrees to all of its terms and conditions. The Employee acknowledges that he has had reasonable time to consider and discuss this Agreement with his attorney. By signing this Agreement, the Employee specifically acknowledges that he has read it; he understands it and knows he is giving up important rights; he agrees with everything in it; he is aware of his right to consult an attorney of his own choice before signing it; and he has signed it knowingly and voluntarily.

(d) This Agreement also constitutes a compromise agreement and notice of final clearance in according with Article 29 of the Severance Payment Law of 1963.

(e) Subject to the registration of the lien according to section 10 below, the parties shall submit to the labor court of Jerusalem a petition in the form attached hereto as EXHIBIT B1, to strike out Motion No. 2977/02 filed by the Employee.

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(f) Immediately upon execution of this Agreement, the parties shall submit to the labor court of Jerusalem the executed petition attached hereto as EXHIBIT B2, requesting the release of the Company's holdings in M.D.T. Protective Industries Ltd. from any limitation or any other obligation undertaken in connection with Motion No. 2977/02 filed by the Employee.

(g) The Company will withdraw the lawsuit filed by it in the New York State Supreme Court, County of New York, and/or any other lawsuit and/or petition filed by it against the Employee, within 5 working days and will submit to the Employee a copy of such petition to dismiss the lawsuit immediately upon its submission.

7. Surviving Terms of Employment Agreement. The Employee acknowledges and agrees that he shall continue to be bound by and comply with the provisions of Section 8 of the Employment Agreement (entitled "Confidentiality; Proprietary Rights; Competitive Activity").

8. Approval. The Company hereby declares that the Company's Board of Directors has approved this Agreement, and empowered Mr. Robert S. Ehrlich to sign this Agreement in the name of EFL & EFC. The resolution adopted by the board and all its details and provisions and authorizing Mr. Ehrlich to sign this Agreement is attached hereto as EXHIBIT C.

9. Attorney Fees. The Company shall pay directly to the Employee's attorney, Dr. J. Segev & Co., of 4 Wisooski St., Tel Aviv, an amount of US \$89,500, as follows:

(a) An amount of US \$34,500, on or prior to January 15, 2003.

(b) An amount of US \$55,000 in ten equal installments of US \$5,500. One such installment shall be due and payable by the last day of each of the months of September and December 2003, March, June, September and December 2004, and March, June, September and December 2005.

(c) The Company will add VAT (at the rate determined by law at the time any payment hereto) to all payments under this Section 9 and receive an invoice for any such payment.

(d) The Company will pay Dr. J. Segev & Co., all sums setforth in this section by direct deposit to Dr. J. Segev & Co.'s bank account at Bank Hapoalim, Pinkas Branch Tel-Aviv (754) Account No. 187772 (or as will be instructed by the employee from time to time, in writing).

(e) This Section 9 and Section 10 below shall constitute an agreement for the benefit of third party.

10. Security. Debts.

- (a) The payments provided in Sections 2 and 9 above shall be secured by a lien in favor of the Employee and/or Dr. J. Segev & Co., that will be registered on those of the assets of EFL that relate exclusively to EFL's Water-Activated Battery line (the "WAB"), the Instant Power consumer battery business, including patents related exclusively thereto, and the Company's rights in the Car, a breakdown of which is provided in EXHIBIT D attached

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hereto ("Lien"). For the avoidance of doubt, it is expressly understood that the Lien shall include only such items provided on EXHIBIT D and shall not include any shares owned by EFL, including without limitations shares of M.D.T. Protective Industries Ltd., and that the Lien shall not include any patents owned by EFC which relate, in whole or in part, to the field of batteries for military use or to electric vehicles. The Company shall be empowered to sell assets subject to the Lien and take off the Lien, and the Employee will make all necessary steps to take off the Lien including but not limited to the prompt execution of any necessary documents, provided that the proceeds from such sale are applied to reduction of the remaining sums to be due at such time under Section 2 and 9 above and that the total consideration of such sale exceeds the remaining sums to be due at such time under Section 2 and 9 above.

- (b) The Company shall maintain the WAB in good condition consistent with its current practice and shall maintain an insurance policy on the WAB.
- (c) During the year 2003 the Company shall maintain the Instant Power consumer battery business in good condition consistent with its current practice. However, the Company may elect at any time during the year 2003 to stop maintaining the Instant Power consumer battery business. In such event the company will notify in writing its decision not to maintain the Instant Power consumer battery business during or after 2003 and the Employee shall have two months in which he may try to sell the Instant Power consumer battery business. During these two months the Company shall continue to maintain the Instant Power consumer battery business in its current condition. In the event that the Employee is successful in selling, the consideration out of the selling will be taken off from the Company payments in section 2

and 9 above. Subject to full maintenance fee such as rent and salaries which will be taken off from the Company Payments in section 2 and 9 above the Employee may prolong in writing the two months in which he will try to sell the Instant Power consumer battery business.

- (d) In the event the Company maintains the Instant Power consumer battery business until October 30 2003 the Company, following the Employee written request, shall notify in writing its decision re the maintenance of the Instant Power consumer battery business and in the event the Company decision is not to continue the maintenance of the Instant Power consumer battery business the Employee shall have two months in which he may try to sell it according to subsection 10 c. To avoid any doubt in no event the employee shall have more than two months to sell and the Company may elect not to maintain the Instant Power consumer battery business after December 31 2003 or during 2003 after the two months given to the Employee for selling according to subsection 10c-10d.

(e) The Company hereby declares that other than its obligations to the Office of the Chief Scientist, all assets to be pledged under section 10 (a) are free from any lien,

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attachment or any other third party rights. The Company's obligations to the Chief Scientist are attached hereto as EXHIBIT E

(f) Upon the execution of this agreement the Company will execute a deed of pledge of the lien in favor of the Employee and/or Dr. J. Segev & Co. to be registered at the Registrar of Pledges and/or the Registrar of Companies. The pledge shall comply with all the obligations of the Company toward the Office of the Chief Scientist.

(g) The parties hereof acknowledge that the only debts which the Employee has to the Company that will continue in existence after the date of this Agreement are the debts in the principal total amount of US \$957,966 ("Debts") for which the Employee has executed non-recourse promissory notes on December 28, 1998 and February 9, 2000 ("Promissory Notes"). The Promissory Notes are attached hereto as EXHIBIT F.

(h) The parties hereof acknowledge that the shares specified in each of the non-recourse Promissory Notes, respectively, are the sole security for the debts provided in sub-section (b) above; that the Debts will be governed only according to the provisions and conditions set forth in each of the Promissory Notes, respectively; that the recourse of the Debts under each of the non-recourse Promissory Notes shall only be the pledged shares specified in each of the Promissory Notes, respectively; and that the Debts will not be released by this Agreement.

(i) Upon any event that the Company becomes adjudged insolvent or a trustee, receiver or similar officer shall be appointed for the Company or any substantial part of its property; or any bankruptcy, reorganization, debt arrangement, recovery process or other proceeding under any bankruptcy or insolvency law or any dissolution or liquidation proceedings shall be instituted by or against the Company, all remaining payments set forth in sections 2 and 9 above will mature immediately and it will enable the Employee and/or Dr. J. Segev & Co. to realize the Lien immediately.

11. Binding Effect. This Agreement be binding upon or injure to the benefit of the successors and assigns of the Company and the Employee and his personal

representative(s).

12. Binding Arbitration.

(a) This Agreement, the performance thereof and all matters arising from and connected with the Agreement, shall be governed by and construed, solely and exclusively, in accordance with the laws of Israel.

(b) Any dispute hereunder shall be finally settled by a binding arbitration held in Tel Aviv, Israel, in the Hebrew language (except that witnesses shall be permitted to speak in English), by one arbitrator, a retired judge with commercial background to be chosen by the parties and if the parties do not consent about the arbitrator, the arbitrator will be appointed by the president of the Israeli Chamber of Certified Accountants. This section constitutes an arbitration agreement.

(c) The decision or award of the arbitrators shall be published to each party and will be final and binding upon all of the parties. Each of the parties hereby irrevocably and expressly agrees to comply promptly and in good faith with any and all such decisions or awards.

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(d) The arbitration hereunder shall be the exclusive and conclusive method for resolving disputes under this Agreement and no court shall have the power to adjudicate such disputes.

(e) The costs of the arbitration, including without limitations attorneys fees, shall be borne by the non-prevailing party.

13. Severability. If one or more of the provisions of this Agreement or any application thereof shall be invalid, illegal, or unenforceable in any respect, the validity, legality and enforceability of the remaining provisions thereof shall in no way be affected or impaired.

14. Entire Agreement. The foregoing contains the entire agreement of the parties and may not be altered, amended, or terminated except by an instrument in writing signed by the parties hereto.

15. Joint and Several Obligations. The obligations and liabilities of each company hereunder (EFC and EFL) shall be joint and several with the obligations and liabilities of the other company hereunder.

16. Execution in counterparts. This agreement may be executed in any number of separate counterparts, each of which shall together be deemed an original, but the several counterparts shall together constitute but one and the same agreements of the parties hereto.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first written above.

ELECTRIC FUEL CORPORATION

By:

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

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

By:

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

Yehuda Harats

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