AROTECH CORP
Form 10-Q
May 17, 2007

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

**FORM 10-Q**

T **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED March 31, 2007 .**
**Commission file number: 0-23336**

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

| | |
|---|---|
| **Delaware** | **95-4302784** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| **1229 Oak Valley Drive, Ann Arbor, Michigan** | **48108** |
| (Address of principal | (Zip |

executive offices) Code)

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

(Former address, if changed since last report)

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

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: o Accelerated filer: o Non-accelerated filer: x

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares outstanding of the issuer's common stock as of May 14, 2007 was 11,983,576.
SEC 1296 (03-07)

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**displays a currently valid OMB control number.**

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**PART I - FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)**

**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(U.S. Dollars)**

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| **ASSETS** | (Unaudited) | |
| | | |
| **CURRENT ASSETS:** | | |
| Cash and cash equivalents | $ 1.1,495,824 | $ 2,368,872 |
| Restricted collateral deposits and restricted held-to-maturity securities | 280,387 | 648,975 |
| Escrow receivable | 1,479,826 | 1,479,826 |
| Available-for-sale marketable securities | 42,341 | 41,166 |
| Trade receivables (net of allowance for doubtful accounts in the amount of $159,000 as of March 31, 2007 and December 31, 2006) | 10,195,816 | 7,780,965 |
| Unbilled receivables | 4,968,323 | 6,902,533 |
| Other accounts receivable and prepaid expenses | 847,467 | 1,134,622 |
| Inventories | 7,753,484 | 7,851,820 |
| ***Total current assets*** | 27,063,468 | 28,208,779 |
| **SEVERANCE PAY FUND** | 2,359,726 | 2,246,457 |
| **OTHER LONG-TERM RECEIVABLES** | 83,785 | 262,608 |
| **PROPERTY AND EQUIPMENT, NET** | 4,662,964 | 3,740,593 |
| **INVESTMENT IN AFFILIATED COMPANY** | 440,019 | 392,398 |
| **OTHER INTANGIBLE ASSETS, NET** | 9,098,172 | 9,502,214 |
| **GOODWILL** | 30,715,225 | 30,715,225 |
| | $ 74,423,359 | $ 75,068,274 |

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

**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(U.S. Dollars, except share data)**

| | March 31, 2007 (Unaudited) | December 31, 2006 |
|---|---|---|
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **CURRENT LIABILITIES:** | | |
| Trade payables | $ 2.3,066,032 | $ 2,808,131 |
| Other accounts payable and accrued expenses | 4,224,686 | 5,171,055 |
| Current portion of capitalized leases | 55,263 | 55,263 |
| Current portion of promissory notes due to purchase of subsidiaries | 302,900 | 302,900 |
| Short-term bank loans and current portion of long-term loans | 3,401,485 | 3,496,008 |
| Deferred revenues | 982,471 | 1,321,311 |
| Convertible debenture | 2,601,097 | 2,583,629 |
| ***Total current liabilities*** | 14,633,934 | 15,738,297 |
| Accrued severance pay | 4,239,862 | 4,039,049 |
| Long-term portion of loans | 1,091,405 | – |
| Long-term portion of promissory notes due to purchase of subsidiaries | 75,725 | 151,450 |
| Long-term portion of capitalized leases | 153,802 | 158,120 |
| ***Total long-term liabilities*** | 5,560,794 | 4,348,619 |
| **MINORITY INTEREST** | 82,176 | 21,520 |
| **SHAREHOLDERS' EQUITY:** | | |
| Share capital – | | |
| Common stock – $0.01 par value each; | | |
| Authorized: 250,000,000 shares as of March 31, 2007 and December 31, 2006; Issued: 12,023,242 shares as of March 31, 2007 and December 31, 2006; Outstanding: 11,983,576 shares as of March 31, 2007 and December 31, 2006 | 120,232 | 120,232 |
| Preferred shares – $0.01 par value each; | | |
| Authorized: 1,000,000 shares as of March 31, 2007 and December 31, 2006; No shares issued and outstanding as of March 31, 2007 and December 31, 2006 | – | – |
| Additional paid-in capital | 218,538,899 | 217,735,860 |
| Accumulated deficit | (160,264,365) | (158,566,123) |
| Treasury stock, at cost (common stock – 39,666 shares as of March 31, 2007 and December 31, 2006) | (3,537,106) | (3,537,106) |
| Notes receivable from shareholders | (1,307,166) | (1,304,179) |
| Accumulated other comprehensive loss | 595,961 | 511,154 |
| ***Total shareholders' equity*** | 54,146,455 | 54,959,838 |
| | $ 74,423,359 | $ 75,068,274 |

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

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

| | Three months ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| Revenues | $ 11,529,162 | $ 8,896,412 |
| Cost of revenues | 7,403,223 | 6,652,752 |
| Amortization of intangible assets | 339,960 | 510,692 |
| Research and development | 498,085 | 304,612 |
| Selling and marketing | 1,030,768 | 899,268 |
| General and administrative | 3,724,290 | 3,102,536 |
| Impairment of goodwill and other intangible assets | – | 204,059 |
| Total operating costs | 12,996,326 | 11,673,919 |
| Operating loss | (1,467,164) | (2,777,507) |
| Other income | 11,944 | 17,506 |
| Financial expenses, net | (124,080) | (1,461,136) |
| Loss before minority interest in loss (earnings) of subsidiaries, earnings from affiliated company and tax expenses | (1,579,300) | (4,221,137) |
| Income tax expenses | (105,907) | (39,972) |
| Minority interest in loss (earnings) of subsidiaries | (60,656) | 9,189 |
| Gain from affiliated company | 47,621 | 38,472 |
| Net loss | $ (1,698,242) | $ (4,213,448) |
| Deemed dividend to certain shareholders | – | (317,207) |
| Net loss attributable to common shareholders | $ (1,698,242) | $ (4,530,655) |
| Basic and diluted net loss per share | $ (0.15) | $ (0.70) |
| Weighted average number of shares used in computing basic and diluted net loss per share | 11,219,131 | 6,480,162 |

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

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

| | Three months ended March 31, | |
|---|---|---|
| | 2007 | 2006 |
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net loss for the period before deemed dividend to certain stockholders of common stock | $ (1,698,242) | $ (4,213,448) |
| Adjustments required to reconcile net loss to net cash used in operating activities: | | |
| Depreciation | 613,110 | 380,078 |
| Amortization of intangible assets, capitalized software costs and impairment of intangible assets | 486,429 | 745,528 |
| Amortization relating to warrants issued to the holders of convertible debentures and beneficial conversion feature | 22,593 | 483,609 |
| Financial expenses in connection with convertible debenture principal repayment | – | 506,960 |
| Amortization of deferred expenses related to convertible debenture issuance | 17,468 | 242,846 |
| Remeasurement of liability in connection with warrants granted | – | (35,270) |
| Stock based compensation due to options and shares granted to employees | 791,996 | 230,941 |
| Earnings (loss) to minority | 60,656 | (9,189) |
| Share in earnings of affiliated company | (47,621) | (38,472) |
| Liability for employee rights upon retirement, net | 87,145 | 115,997 |
| Write-off of inventory | – | 70,577 |
| Decrease in deferred tax assets | 13,002 | 7,564 |
| Changes in operating asset and liability items: | | |
| Capital loss from sale of property and equipment | 3,232 | – |
| Decrease (increase) in trade receivables and notes receivable | (2,238,114) | 3,967,096 |
| Decrease (increase) in unbilled receivables | 1,934,210 | (87,515) |
| Decrease (increase) in other accounts receivable and prepaid expenses | 262,556 | (91,927) |
| Decrease in inventories | 103,701 | 146,995 |
| Decrease (increase) in trade payables | 253,983 | (2,893,400) |
| Decrease (increase) in deferred revenues | (338,840) | 519,418 |
| Decrease in accounts payable and accruals | (1,138,943) | (639,714) |
| ***Net cash used in operating activities from continuing operations*** | (811,679) | (591,326) |
| ***Net cash used in operating activities from discontinuing operations*** | – | (120,000) |
| ***Net cash used in operating activities*** | (811,679) | (711,326) |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Purchase of property and equipment | (1,535,555) | (128,132) |
| Increase in capitalized research and development projects | – | (202,607) |
| Decrease (increase) in restricted securities and deposits, net | 368,589 | (2,864,139) |
| ***Net cash used in investing activities*** | (1,166,966) | (3,194,878) |
| **FORWARD** | $ (1,978,645) | $ (3,906,204) |

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

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

| | Three months ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| **FORWARD** | $ (1,978,645) | $ (3,906,204) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Decrease in short-term credit from banks | (1,432) | (133,747) |
| Proceeds from exercise of warrants | – | 3,195,772 |
| Proceeds from exercise of options to employees and consultants | 37,642 | – |
| Increase in long term debt | 1,115,000 | – |
| Repayment of long-term loans | – | (9,906) |
| ***Net cash provided by financing activities*** | 1,151,210 | 3,052,119 |
| **DECREASE IN CASH AND CASH EQUIVALENTS** | (827,435) | (854,085) |
| **CASH ACCRETION (EROSION) DUE TO EXCHANGE RATE DIFFERENCES** | (45,613) | 15,347 |
| **BALANCE OF CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD** | 2,368,872 | 6,150,651 |
| **BALANCE OF CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD** | $ 1,495,824 | $ 5,311,913 |
| **SUPPLEMENTARY INFORMATION ON NON-CASH TRANSACTIONS:** | | |
| Payment of principal installment of convertible debenture in shares | $ – | $ 2,463,615 |
| Warrants exercise against note receivable from shareholder | $ – | $ 577,051 |
| Liability in connection with warrants issuance | $ – | $ 775,305 |

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

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

**NOTE 1: BASIS OF PRESENTATION**

a. Company:

Arotech Corporation ("Arotech" or the "Company"), and its subsidiaries provide defense and security products for the military, law enforcement and homeland security markets, including advanced zinc-air and lithium batteries and chargers, multimedia interactive simulators/trainers and lightweight vehicle armoring. The Company is primarily operating through FAAC Corporation ("FAAC"), a wholly-owned subsidiary based in Ann Arbor, Michigan, and FAAC's 80%-owned United Kingdom subsidiary FAAC Limited; IES Interactive Training, Inc. ("IES"), a wholly-owned subsidiary based in Ann Arbor, Michigan; Electric Fuel Battery Corporation ("EFB"), 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. ("Epsilor"), a wholly-owned subsidiary located in Dimona, Israel; MDT Protective Industries, Ltd. ("MDT"), a majority-owned subsidiary based in Lod, Israel; MDT Armor Corporation ("MDT Armor"), a majority-owned subsidiary based in Auburn, Alabama; and Armour of America, Incorporated ("AoA"), a wholly-owned subsidiary based in Auburn, Alabama.

b. Basis of presentation:

The accompanying interim condensed consolidated financial statements have been prepared by Arotech Corporation in accordance with generally accepted accounting principles for interim financial information, with the instructions to Form 10-Q and with Article 10 of Regulation S-X, and include the accounts of Arotech Corporation and its subsidiaries. Certain information and footnote disclosures, normally included in complete financial statements prepared in accordance with generally accepted accounting principles, have been condensed or omitted. In the opinion of the Company, the unaudited financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of its financial position at March 31, 2007, its operating results for the three-month periods ended March 31, 2007 and 2006 and its cash flow for the three-month periods ended March 31, 2007 and 2006.

The results of operations for the three months ended March 31, 2007 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year ending December 31, 2007.

The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

c. Accounting for stock-based compensation:

For the three months ended March 31, 2007 and 2006 the compensation expense recorded related to stock options and restricted shares was $791,996 and $230,941, respectively, of which $53,812 and $47,665, respectively, was for stock options and $738,184 and $183,276, respectively, was for restricted shares. The remaining total compensation cost related to non-vested stock options and restricted share awards not yet recognized in the income statement as of March

31, 2007 was $1,684,674, of which $230,981 was for stock options and $1,453,693 was for restricted shares. The weighted average period over which this compensation cost is expected to be recognized is approximately 16 months.

Income tax expense was not impacted since the Company is in a net operating loss position and does not record income tax expense.

The Company applies SFAS No. 123 and Emerging Issues Task Force No. 96-18, “Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services” (“EITF 96-18”), with respect to options and warrants issued to non-employees. SFAS No. 123 and EITF 96-18 require the use of option valuation models to measure the fair value of the options and warrants at the measurement date.

There were no new options or restricted stock issued in the first quarter and no options were exercised in the first quarter.

d. Reclassification:

Certain comparative data in these financial statements have been reclassified to conform with the current year’s presentation.

e. Reverse split:

The Company’s shareholders approved a one-for-fourteen reverse stock split of the Company’s common stock on June 19, 2006, which was effected on June 21, 2006. 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 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. All shares of common stock, options, warrants, option and warrant exercise prices, convertible debt conversion prices and per share data included in these financial statements for all periods prior to June 21, 2006 presented have been retroactively adjusted to reflect this one-for-fourteen reverse split.

f. Anti-dilutive shares for EPS calculation

All outstanding stock options, non-vested restricted stock and warrants have been excluded from the calculation of the diluted net loss per common share because all such securities are anti-dilutive for the 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 1,871,826.

**NOTE 2: INVENTORIES**

Inventories are stated at the lower of cost or market value. Cost is determined using the average cost method. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on these evaluations, provisions are made in each period to write down inventory to its net realizable value. Inventory write-offs are provided to cover risks arising from slow-moving items, technological obsolescence, excess inventories, and for market prices lower than cost. In the three months ended

March 31, 2007, the Company did not adjust the inventory. Inventories are composed of the following:

| | March 31, 2007 | December 31, 2006 |
|---|---|---|
| | (Unaudited) | |
| Raw and packaging materials | $ 5,808,506 | $ 4,556,250 |
| Work-in-progress | 1,838,212 | 3,186,843 |
| Finished goods | 106,766 | 108,727 |
| | $ 7,753,484 | $ 7,851,820 |

**NOTE 3: IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS**

Effective January 1, 2007, the first day of fiscal 2007, the Company adopted SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments," to simplify the accounting for certain hybrid instruments. The adoption of this statement did not have a material effect on the consolidated financial condition or results of operations as the Company had no hybrid instruments to which SFAS No. 155 applies.

Effective January 1, 2007, the first day of fiscal 2007, the Company adopted SFAS No. 156, "Accounting for Servicing of Financial Assets," which addresses the recognition and measurement of separately recognized servicing assets and liabilities. The adoption of this statement did not have a material effect on the consolidated financial condition or results of operations.

Effective January 1, 2007, the first day of fiscal 2007, the Company adopted 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. See Note 6 below for additional information, including the effects of adoption on the Company's consolidated financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements,"("SFAS No. 157") 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.

In December 2006, the FASB issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) No. 00-19-2, "Accounting for Registration Payment Arrangements," which requires an issuer to account for a contingent obligation to transfer consideration under a registration payment arrangement in accordance with FASB Statement No. 5, "Accounting for Contingencies," and FASB Interpretation No. 14, "Reasonable Estimation of the Amount of Loss." Registration payment arrangements are frequently entered into in connection with issuance of unregistered financial instruments, such as equity shares or warrants. A registration payment arrangement contingently obligates the issuer to make future payments or otherwise transfer consideration to another party if the issuer fails to file a registration statement with the SEC for the resale of specified financial instruments or fails to have the registration statement declared effective within a specific period. The FSP requires issuers to make certain disclosures for each registration payment arrangement or group of similar arrangements. The FSP is effective immediately for registration payment arrangements and financial instruments entered into or modified after the FSP's issuance date. For previously issued registration payment arrangements and financial instruments subject to those arrangements, the FSP is effective for financial statements issued for fiscal years beginning after December 15, 2006. To the extent that the Company enters into financing arrangements in the future that include registration payment arrangements, the future application of this FSP may have a material effect on our financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," ("SFAS No. 159") which permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 applies to all entities and is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 159 on the Company's financial statements.

**NOTE 4: SEGMENT INFORMATION**

a. General:

The Company and its subsidiaries operate primarily in three business segments and follow the requirements of SFAS No. 131.

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 used by the Company in the preparation of its annual financial statement. The Company evaluates performance based upon two primary factors, one is the segment's operating income and the other is the segment's contribution to the Company's future strategic growth.

b. The following is information about reported segment revenues, income (losses) and total assets for the three months ended March 31, 2007 and 2006:

| | Simulation and Training | Battery and Power Systems | Armor | All Others | Total |
|---|---|---|---|---|---|
| **Three months ended March 31, 2007** | | | | | |
| Revenues from outside customers | $ 4,216,008 | $ 2,539,132 | $ 4,774,022 | $ – | $ 11,529,162 |
| Depreciation, amortization and impairment expenses (1) | (398,876) | (237,920) | (188,960) | (59,302) | (885,058) |
| Direct expenses (2) | (3,210,791) | (2,621,243) | (3,925,755) | (2,460,477) | (12,218,266) |
| Segment income (loss) | $ 606,341 | $ (320,031) | $ 659,307 | $ (2,519,779) | (1,574,162) |
| Financial expense | | | | | (124,080) |
| Loss from continuing operations | | | | | $ (1,698,242) |
| Segment assets (3), (4) | $ 42,851,260 | $ 18,369,473 | $ 10,801,573 | $ 2,401,053 | $ 74,423,359 |
| **Three months ended March 31, 2006** | | | | | |
| Revenues from outside customers | $ 4,936,565 | $ 2,041,942 | $ 1,917,905 | $ – | $ 8,896,412 |
| Depreciation, amortization and impairment expenses (1) | (433,709) | (232,197) | (399,874) | (59,826) | (1,125,606) |
| Direct expenses (2) | (4,195,347) | (2,151,262) | (2,356,205) | (1,820,304) | (10,523,118) |
| Segment income (loss) | $ 307,509 | $ (341,517) | $ (838,174) | $ (1,880,130) | (2,752,312) |
| Financial expense | | | | | (1,461,136) |
| Loss from continuing operations | | | | | $ (4,213,448) |
| Segment assets (3), (4) | $ 44,005,859 | $ 16,299,877 | $ 8,932,609 | $ 12,371,120 | $ 81,609,464 |

(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 our Simulation and Training, Battery and Power Systems and Armor Divisions stood at $24,235,419, $5,413,210 and $1,066,596, respectively, as of March 31, 2007 and $23,605,069, $4,902,639 and $973,352, respectively, as of March 31, 2006.

**NOTE 5: CONVERTIBLE DEBENTURES, DETACHABLE WARRANTS AND LONG TERM DEBT**

a. 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 (“Notes”) having a final maturity date of March 31, 2008.

Under the terms of the Purchase Agreement, the Company 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 the Company’s 8% secured convertible debentures due September 30, 2006, since terminated) and in the assets of FAAC Incorporated (junior to a bank that extends to FAAC Incorporated a $6 million line of credit) and in any stock that the Company acquires in future acquisitions, and (ii) a first position security interest in the assets of all of the Company’s other active United States subsidiaries. The Company’s active United States subsidiaries are also acting as guarantors of the Company’s obligations under the Notes.

As of March 31, 2007, the principal amount of $2.6 million remained outstanding under these convertible 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 our common stock during 17 of the 20 consecutive trading days ending two days before the payment date.

In connection with these convertible notes, the Company will recognize financial expenses of $422,034 with respect to assigning fair value to the warrants issued to the holders of the convertible debenture, which is being amortized from the date of issuance to the stated redemption date – March 31, 2008 – 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.

During the three months ended March 31, 2007, the Company recorded an expense of approximately $17,000, which was attributable to amortization of the beneficial conversion feature of the convertible notes over their term. These expenses were included in the financial expenses.

b. Mortgage Note, Auburn, Alabama:

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. The note requires a payment (principal and interest) of approximately $9,300 per month at an interest rate of 8% per annum. The balance of this note is shown in the short and long term sections of the balance sheet.

**NOTE 6: INCOME TAXES**

As highlighted in Note 3 above, the Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company did not record a liability for unrecognized tax positions. The adoption of FIN 48 did not impact our financial condition, results of operations or cash flows. At December 31, 2006, we had net deferred tax assets of $39.5 million. The deferred tax assets are primarily composed of federal, state and foreign tax net operating loss ("NOL") carryforwards. Due to uncertainties surrounding our ability to generate future taxable income to realize these assets, a full valuation has been established to offset our net deferred tax asset. Additionally, the future utilization of our NOL carryforwards to offset future taxable income may be subject to a substantial annual limitation as a result of ownership changes that may have occurred previously or that could occur in the future. We have not yet determined whether such an ownership change has occurred. However, the Company plans to complete a Section 382 analysis regarding the limitation of the net operating losses. When this project is completed, the Company plans to update the unrecognized tax benefits under FIN 48. Therefore, the Company expects that the unrecognized tax benefits may change within 12 months of this reporting date. At this time, the Company cannot estimate how much the unrecognized tax benefits may change. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in our unrecognized tax benefits will not impact our effective tax rate.

At least three years of the Company's federal returns are still open for examination, so it is possible that the amount of this liability could change in future accounting periods.

The Company files income tax returns, including returns for its subsidiaries, with federal, state, local and foreign jurisdictions. The Company is no longer subject to IRS examination for periods prior to 2002, although carryforward losses that were generated prior to 2002 may still be adjusted by the IRS if they are used in a future period. Additionally, the Company is no longer subject to examination in Israel for periods prior to 2002.

Interest and penalties, when accrued, relating to income tax liabilities are included in income tax expense. As of March 31, 2007, the Company had not accrued any interest or penalties relating to income taxes.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*This report contains forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements involve inherent risks and uncertainties. When used in this discussion, the words "believes," "anticipated," "expects," "estimates" and similar expressions are intended to identify such forward-looking statements. Such statements are subject to certain risks and uncertainties. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors including, but not limited to, those set forth elsewhere in this report. Please see "Risk Factors," below, and in our other filings with the Securities and Exchange Commission.*

*Arotech™ is a trademark and Electric Fuel® is a registered trademark of Arotech Corporation. All company and product names mentioned may be trademarks or registered trademarks of their respective holders. Unless the context requires otherwise, all references to us refer collectively to Arotech Corporation and its subsidiaries.*

*We make available through our internet website free of charge our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to such reports and other filings made by us with the SEC, as soon as practicable after we electronically file such reports and filings with the SEC. Our website address is www.arotech.com. The information contained in this website is not incorporated by reference in this report.*

The following discussion and analysis should be read in conjunction with the interim financial statements and notes thereto appearing elsewhere in this Quarterly Report. We have rounded amounts reported here to the nearest thousand, unless such amounts are more than 1.0 million, in which event we have rounded such amounts to the nearest hundred thousand.

### Executive Summary

#### *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:

Ø 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

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- IES Interactive Training, Inc., located in Ann Arbor, Michigan, which provides specialized "use of force" training for police, security personnel and the military ("IES").

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

- Armour of America, located in Auburn, Alabama, which manufactures 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).

Ø 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 battery ("WAB") 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 and 2006 and for the first three months of 2007. While we expect to continue to derive revenues from the sale of products that our subsidiaries manufacture and the services that they 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. In the first three months of 2007 we had a net loss of $1.7 million on revenues of $11.5 million, compared to the first three months of 2006, when we had a net loss of $4.2 million on revenues of $8.9 million.

*Acquisitions*

In acquisitions 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 an intangible asset has been impaired, we must record the impairment charge in our statement of operations.

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

As a result of the application of the above accounting rules, we incurred non-cash charges for amortization of intangible assets in the amount of $339,000 during the first three months of 2007.

*Issuances of Restricted Shares, Options and Warrants*

During 2006, 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 $738,000 during the first three months of 2007.

As a result of stock options granted to employees and directors 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 $54,000 during the first three months of 2007.

***Overview of Operating Performance and Backlog***

Overall, our net loss before minority interest earnings, earnings from affiliated company and tax expenses for the three months ended March 31, 2007 was $1.6 million on revenues of $11.5 million, compared to a net loss of $4.2 million on revenues of $8.9 million during the three months ended March 31, 2006. As of March 31, 2007, our overall backlog totaled $40.3 million.

In our Simulation and Training Division, revenues decreased from approximately $4.9 million in the first three months of 2006 to $4.2 million in the first three months of 2007. As of March 31, 2007, our backlog for our Simulation and Training Division totaled $11.5 million.

In our Battery and Power Systems Division, revenues increased from approximately $2.0 million in the first three months of 2006 to approximately $2.5 million in the first three months of 2007. As of March 31, 2007, our backlog for our Battery and Power Systems Division totaled $10.0 million.

In our Armor Division, revenues increased from $1.9 million during the first three months of 2006 to $4.8 million during the first three months of 2007. As of March 31, 2007, our backlog for our Armor Division totaled $18.8 million.

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

**Results of Operations**

***Three months ended March 31, 2007 compared to the three months ended March 31, 2006.***

***Revenues.*** During the three months ended March 31, 2007, we (through our subsidiaries) recognized revenues as follows:

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

- Ø 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.

- Ø 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.

- Ø EFL recognized revenues from the sale of water-activated battery (WAB) lifejacket lights.

Revenues for the three months ended March 31, 2007 totaled $11.5 million, compared to $8.9 million in the comparable period in 2006, an increase of $2.6 million, or 29.6%. In the first quarter of 2007, revenues were $4.2 million for the Simulation and Training Division (compared to $4.9 million in the first quarter of 2006, a decrease of $721,000, or 14.6%); $2.5 million for the Battery and Power Systems Division (compared to $2.0 million in the first quarter of 2006, an increase of $497,000, or 24.3%, due primarily to increased sales of Epsilor and EFB); and $4.8 million for the Armor Division (compared to $1.9 million in the first quarter of 2006, an increase of $2.9 million, or 148.9%, due primarily to increased revenues from MDT and MDT Armor, mostly in respect of orders for the "David" Armored Vehicle).

***Cost of revenues.*** Cost of revenues totaled $7.4 million during the first quarter of 2007, compared to $6.7 million in the first quarter of 2006, an increase of $750,000, or 11.3%, due primarily to production of a new product in our Armor Division and the decrease in margins due to change in the mix of products and customers in 2007 in comparison to 2006.

Direct expenses for our three divisions during the first quarter of 2007 were $3.2 million for the Simulation and Training Division (compared to $4.2 million in the first quarter of 2006, a decrease of $1.0 million, or 23.5%, due primarily to decreased sales of FAAC); $2.6 million for the Battery and Power Systems Division (compared to $2.2 million in the first quarter of 2006, an increase of $470,000, or 21.8%, due primarily to increased revenues; and $3.9 million for the Armor Division (compared to $2.4 million in the first quarter of 2006, an increase of $1.5 million, or 66.6%, due primarily to production of the "David" Armored Vehicle.)

***Amortization of intangible assets.*** Amortization of intangible assets totaled $340,000 in the first quarter of 2007, compared to $511,000 in the first quarter of 2006, a decrease of $171,000, or 33.4%, due primarily to a decrease in amortization of intangible assets related to our subsidiary AoA.

***Research and development expenses.*** Research and development expenses for the first quarter of 2007 were $498,000, compared to $305,000 during the first quarter of 2006, an increase of $193,000, or 63.5%. This increase was primarily attributable to increases in expenses at

Epsilor and EFL for design improvements and at FAAC for expenses associated with the improvements to the Company's simulator products.

***Selling and marketing expenses.*** Selling and marketing expenses for the first quarter of 2007 were $1.0 million, compared to $899,000 the first quarter of 2006, an increase of $132,000, or 14.6%. This increase was primarily attributable to the overall increase in revenues and their associated sales and marketing expenses.

***General and administrative expenses.*** General and administrative expenses for the first quarter of 2007 were $3.7 million compared to $3.1 million in the first quarter of 2006, an increase of $622,000, or 20.0%. This increase was primarily attributable to stock compensation expense incurred in respect of restricted shares granted to the executive officers of the Company.

***Financial expenses, net.*** Financial expenses totaled approximately $124,000 in the first quarter of 2007 compared to $1.5 million in the first quarter of 2006, a decrease of $1.3 million, or 91.5%. The difference was due primarily to decreased interest related to our convertible notes that were issued in March 31, 2006 as a result of payments of principal during 2006, and financial expenses in 2006 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 that did not occur in the first three months of 2007.

***Income taxes.*** We and certain of our subsidiaries incurred net operating losses during the three months ended March 31, 2007 and accordingly, no provision for income taxes was recorded. With respect to some of our subsidiaries that operated at a net profit during 2007, we were able to offset federal taxes against our accumulated loss carry forward. We recorded a total of $106,000 in tax expense in the first quarter of 2007, compared to $40,000 in tax expense in the first quarter of 2006, mainly concerning state taxes.

***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 first quarter of 2007. In the corresponding period of 2006, we identified in AoA an impairment of goodwill in the amount of $204,000.

***Net loss.*** Due to the factors cited above, net loss decreased from $4.2 million in 2006 to $1.7 million in 2007, a decrease of $2.5 million, or 59.7%. (Net loss attributable to common stockholders was $4.5 million in 2006, due to a deemed dividend that was recorded in the amount of $317,000 in 2006 due to the repricing of existing warrants and the issuance of new warrants.)

**Liquidity and Capital Resources**

As of March 31, 2007, we had $1.5 million in cash, $280,000 in restricted collateral securities and restricted held-to-maturity securities due within one year, $1.5 million in an escrow receivable, and $42,000 in available-for-sale marketable securities, as compared to December 31, 2006, when we had $2.4 million in cash, $649,000 in restricted collateral securities and restricted held-to-maturity securities due within one year, $1.5 million in an escrow receivable and $41,000 in available-for-sale marketable securities.

We used available funds in the three months ended March 31, 2007 primarily for sales and marketing, continued research and development expenditures, and other working capital needs. We increased our investment in fixed assets (including the purchase of two buildings in Alabama) during the three months ended March 31, 2007 by $1.5 million over the investment as at December 31, 2006. Our net fixed assets amounted to $4.7 million at quarter end.

Net cash used in operating activities from continuing operations for the three months ended March 31, 2007 and 2006 was $812,000 and $591,000, respectively, an increase of $221,000. This increase in cash used was primarily the result of changes in working capital.

Net cash used in investing activities for the three months ended March 31, 2007 and 2006 was $1.2 million and $3.2 million, a decrease of $2.0 million. This decrease was primarily the result of the change in restricted securities and deposits.

Net cash provided by financing activities for the three months ended March 31, 2007 and 2005 was $1.2 million and $3.1 million, respectively. This decrease was primarily the result of warrant exercises in February, March and April of 2006 that had no equivalent in 2007.

As of March 31, 2007, 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 $6.0 million in bank and certificated debt outstanding, $2.6 million of which was convertible debt, and approximately $3.4 million in short-term debt.

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 and in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006, as amended, including without limitation (i) that we will be able to refinance, restructure or convert to equity our $2.6 million in convertible notes that is due in 2007 (which does not include $3.4 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 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.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

### Interest Rate Risk

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

### Foreign Currency Exchange Rate Risk

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 gains and losses in 2007. Certain of our research, development and production activities are carried out by our Israeli subsidiary, EFL, at its facility in Beit Shemesh, and accordingly we have sales and expenses in NIS. Additionally, our MDT and Epsilor subsidiaries operate primarily in NIS. 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.

While we conduct our business primarily in U.S. dollars, some of our agreements are denominated in foreign currencies, and we occasionally hedge part of the risk of a devaluation of the U.S dollar, which could have an adverse effect on the revenues that we incur in foreign currencies. We do not hold or issue derivative financial instruments for trading or speculative purposes

## ITEM 4. CONTROLS AND PROCEDURES.

### Evaluation of Disclosure Controls and Procedures

As of March 31, 2007, 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 objective 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 evaluations, 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 as of March 31, 2007 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.

**Changes in Internal Controls Over Financial Reporting**

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

# PART II

## ITEM 1. LEGAL PROCEEDINGS.

***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. The Complaint 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. Two similar cases were apparently filed in the United States District Court for the Eastern District of New York in May 2007.

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.

***AoA Arbitration***

On March 20, 2007, we filed a Demand for Arbitration with the American Arbitration Association against the person from whom we purchased our Armor of America subsidiary (the "Seller"). In our demand, we seek the return of $3 million, plus interest, held in escrow by the Seller in connection with his sale of AoA to us in 2004. The parties had agreed in 2004 that the Seller would be entitled to all or part of the $3 million if AoA achieved certain levels of sales to certain customers by December 31, 2006. As of December 31, 2006, AoA had not achieved sales sufficient to entitle the Seller to the $3 million. In our demand, we seek the return of the escrowed funds.

The Seller has asserted counterclaims against us in the arbitration, alleging (i) that he is entitled to keep the $3 million, (ii) that he is entitled to an additional $3 million in post-sale earnouts, and (iii) that he is entitled to $70,000 in compensation (plus interest and statutory penalties) wrongfully withheld by us when we constructively terminated his employment. We believe that the Seller's counterclaims are without merit, and will pursue our own claims, and contest the Seller's counterclaims, vigorously.

## ITEM 1A. RISK FACTORS.

The following factors, among others, which may contain changes from risk factors as previously disclosed in our Form 10-K for the year ended December 31, 2006, 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 March 31, 2007, we had an accumulated deficit of approximately $160.5 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 $6.0 million principal amount as of March 31, 2007 (not including trade payables, other accounts payable 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. The principal amount of the notes was payable 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 were 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 was 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 (deferred by agreement to June 30, 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 (deferred by agreement to June 30, 2007) and most of the payment of July 31, 2007 remaining, which represents approximately $2.6 million of outstanding principal under the Notes. 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 Epsilor 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 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 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.

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

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

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

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

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

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

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

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

***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 March 31, 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 March 31, 2007, there were outstanding warrants to purchase a total of 674,707 shares of our common stock at a weighted average exercise price of $13.27 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 Epsilor, are located in Israel (in Beit Shemesh, Lod and Dimona, respectively, all of which are within Israel's pre-1967 borders). Most of our senior management is located at EFL's facilities. Although we expect that most of our 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 continue to 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 and in the first three months of 2007, 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 6. EXHIBITS.**

The following documents are filed as exhibits to this report:

| Exhibit Number | Description |
|---|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: May 17, 2007

**AROTECH CORPORATION**

By: /s/ Robert S. Ehrlich
Name: Robert S. Ehrlich
Title: Chairman and CEO
(Principal Executive Officer)

By: /s/ Thomas J. Paup
Name: Thomas J. Paup
Title: Vice President – Finance and CFO
(Principal Financial Officer)

**EXHIBIT INDEX**

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