

APPLIED ENERGETICS, INC.  
Form 10-K  
March 16, 2010

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

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the fiscal year ended December 31, 2009

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-14015

Applied Energetics, Inc.  
(Exact Name of Registrant as Specified in Its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

77-0262908  
(IRS Employer Identification  
Number)

3590 East Columbia Street  
Tucson, Arizona  
(Address of Principal Executive Offices)

85714  
(Zip Code)

Registrant's telephone number, including area code (520) 628-7415  
Securities registered pursuant to Section 12(b) of the Exchange Act:

|                                |   |
|--------------------------------|---|
| Title of Each Class            | Name of Each Exchange on Which Registered           |
| Common Stock, \$.001 par value | The NASDAQ Stock Market LLC (Nasdaq Capital Market) |

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

None

\_\_\_\_\_  
(Title of Class)

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

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

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

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

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller reporting company

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, computed by reference to the last reported sales price at which the stock was sold on June 30, 2009 (the last day of the registrant's most recently completed second quarter) was approximately \$38,521,000.

The number of outstanding shares of the registrant's Common Stock, \$.001 par value, as of March 12, 2010 was 89,065,252.

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APPLIED ENERGETICS, INC.  
ANNUAL REPORT ON FORM 10-K  
FOR THE YEAR ENDED DECEMBER 31, 2009  
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## PART I

### ITEM 1. BUSINESS

#### Cautionary Note Concerning Forward-Looking Statements

Certain statements in this Form 10-K constitute forward-looking statements within the meaning of the Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include all statements that do not relate solely to the historical or current facts, and can be identified by the use of forward looking words such as "may", "believe", "will", "expect", "expected", "project", "anticipate", "anticipated", "estimates", "plans", "strategy", "target", "prospects" or "continue". These forward looking statements are based on the current plans and expectations of our management and are subject to a number of uncertainties and risks that could significantly affect our current plans and expectations, as well as future results of operations and financial condition and may cause our actual results, performances or achievements to be materially different from any future results, performances or achievements expressed or implied by such forward-looking statements. This Form 10-K contains important information as to risk factors under Item 1A. In making these forward-looking statements, we claim the protection of the safe-harbor for forward-looking statements contained in the Private Securities Reform Act of 1995. Although we believe that the expectations reflected in such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to have been correct. We do not assume any obligation to update these forward-looking statements to reflect actual results, changes in assumptions, or changes in other factors affecting such forward-looking statements.

#### Available Information

Applied Energetics, Inc. makes available free of charge on its website at [www.appliedenergetics.com](http://www.appliedenergetics.com) its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practical after electronically filing or furnishing such material to the Securities and Exchange Commission (SEC).

This report may be read or copied at the SEC's Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549 or at [www.sec.gov](http://www.sec.gov). Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330.

#### General

Applied Energetics, Inc. ("company", "Applied Energetics", "we", "our" or "us") is a developer and manufacturer of high energy systems for military and commercial applications. We advance the state-of-the-art in high performance lasers, high-voltage electronics, advanced optics and atmospheric and plasma interactions. We deliver innovative and high quality systems to meet urgent military missions, including countering improvised explosive devices ("Counter-IEDs" or "CIED"). We develop and manufacture specialized high-voltage and laser products for government and commercial customers for a range of applications. As a technology leader in these fields, we work with our customers to advance the performance of our systems to meet their needs.

Applied Energetics, Inc is a corporation organized and existing under the laws of the State of Delaware. Our executive office is located at 3590 East Columbia Street, Tucson, Arizona, 85714 and our telephone number is (520) 628-7415.

LGETM and LIPC® Technologies

Applied Energetics is the developer of Laser Guided Energy (“LGETM”) and Laser Induced Plasma Channel (LIPC®) technologies. These revolutionary technologies can precisely deliver high voltage electrical charges by using a laser to create a conductive path in the atmosphere. We are developing applications that can deliver tailored weapon and countermeasure effects to targets with laser accuracy, and with manageable effects to reduce the potential for inadvertent injury and minimize collateral damage. This technology has been in development since our inception in 2002, and we have protected what we believe to be the enabling intellectual property through U.S. Patent filings. LGE development has been funded through multiple Department of Defense (“DoD”) contracts in support of U.S. Navy, Army, Air Force, and the Office of Secretary of Defense programs, as well as through internally funded research initiatives.

### Counter-IED Technologies

Working with the United States Marine Corps, we have developed and delivered a system that demonstrates significant capability in countering IEDs; a major threat to military operations throughout the world. Technical and field results of such CIED technologies are highly sensitive or classified, but we are satisfied that our technology has performed well in addressing this critical mission. We have integrated our CIED technologies into military vehicles. We anticipate additional product variations may be utilized on other military platforms in the future as military customers identify new mission areas for implementation of our technologies. We continue to work actively with our customers to field these innovative CIED technologies.

### High-Voltage Technologies

Since the company's inception, we have acquired and developed unique high-voltage capabilities ("HV"). Operating within the company is a group focused on providing high-voltage solutions for semiconductor, aerospace, chemical processing, and other military and commercial activities. Opportunities currently in process or under development include advanced electron-beam technologies, nested high-voltage generators and other unique power solutions for use in a wide range of commercial and military applications.

### Laser Technologies

The company designs and builds solid state lasers for military and commercial applications. The company has the expertise to build uniquely capable, rugged ultra-short pulse lasers and is in the process of developing laser systems for military customers.

### Patents and Proprietary Information

Since our inception, we have pursued the development of a range of core intellectual property objectives using internal investment, and have aggressively pursued patents on such technology. The objective of this approach has been to establish a sole source role for us in customer-funded technology and product development contracts, as well as to protect the value of the intellectual property that we create. Our patent applications, in tandem with our significant proprietary knowledge, may be used as justification for sole source contracts in accordance with Federal Acquisition Regulations, and thereby may improve our competitive position. Presently, nine U.S. Patents have been issued and thirty U.S. patent applications are pending. We have received U.S. Government initiated "national security related" secrecy orders for fourteen of the thirty pending patent applications. The U.S. Patent and Trademark Office imposes secrecy orders when disclosure of an invention by publication of a patent would be detrimental to the United States' national security. These patents are treated as under review unless and until they are declassified, at which time patents may be issued, with enforcement based on the original filing date. We have thus far received notice that eight of these patent applications under secrecy order have been found patentable by the U.S. Patent Office. These patents and patent applications relate to our core LIPC technology, CIED offerings, and other technologies related to LGE, laser and high voltage applications.

### Customer Dependency

Revenue is derived from contracts with Government agencies or contractors to the Government representing approximately 97% and 87%, of total revenue for 2009 and 2008, respectively. The loss of any of these customers would have a material adverse effect on Applied Energetics. All contracts are subject to renegotiation of profits or termination at the election of the Government. When we refer to "Government" we mean the U.S. Government and its agencies. In the third quarter of 2009, we initiated a new strategic plan. The objective of this effort was to identify the areas in which our core strengths can be developed to increase our business across new applications in the

military, government and commercial sectors. The goals for the strategic plan include increasing revenues, achieving positive cash flow, profitability, development of new products and markets, diversifying our customer base and controlling costs to improve margins.

#### Competition

Currently, substantially all of our activity and revenue is generated through contracts with agencies of the Government focused on military and national security applications. We have developed, demonstrated, and advanced innovative directed-energy technologies. We believe that we are the only company in the United States that is providing the Government access to these unique technologies. However, we face competition from other domestic companies within the defense industry and other companies with differing technologies that seek to provide similar benefits or address similar missions as our technologies. Additionally, foreign countries and companies may be developing technologies that may compete with our technologies.



## Research and Development

We fund our research and development primarily through internal investment and we diligently attempt to retain the sole ownership of all of the key intellectual property. We believe control of the core intellectual property we have developed is necessarily critical to our advancement of the LIPC, CIED and HV technologies. We occasionally outsource research tasks to experienced individuals or companies for activities that require equipment or modeling capabilities that we do not have internally available, preserving our intellectual property.

Our short-term research and development goals are to develop efficient and compact laser sources, novel high-voltage electrical sources, efficient optical systems and to turn the technologies we have developed for new government and commercial applications and markets into products.

Our research and development expense for 2009 and 2008 was \$1,182,652, and \$1,372,396, respectively.

## Backlog of Orders

At December 31, 2009 and 2008, respectively, we had a backlog (i.e. work load remaining on signed contracts) of approximately \$3.4 million, and \$4.6 million, respectively, to be completed within the twelve months following those dates. As of February 28, 2010, our backlog was \$11.6 million.

## Employees

As of December 31, 2009, we had 49 full time employees. During the second quarter, the company initiated a process whereby each product line was evaluated for appropriate levels of staffing given current and anticipated contract activities, timing of deliverables and general expected economic conditions. Following this evaluation, on May 7, 2009, the company reduced its staffing by 20 individuals. This included the shut down of operations at our St. Louis facility and the associated reduction in the entire staff located there.

## ITEM 1A. RISK FACTORS

Future results of operations of Applied Energetics involve a number of known and unknown risks and uncertainties. Factors that could affect future operating results and cash flows and cause actual results to vary materially from historical results include, but are not limited to those risks set forth below:

### Risk Related to Our Business

Our growth is subject to a number of economic risks.

As widely reported, financial markets have recently experienced disruption, including, among other things, volatility in securities prices, diminished liquidity and credit availability, ratings downgrades of certain investments and declining valuations of others. The recent economic downturn has resulted in restricted credit, depressed sales in the retail sector and declines in real estate values. Governments have taken unprecedented actions intended to address these unfavorable market conditions. While currently these conditions have not impaired our ability to access credit markets and finance our operations, there can be no assurance that there will not be a continued deterioration in financial markets and confidence in major economies such that our ability to access credit markets and finance our operations might be impaired. There can also be no assurance that government actions made in response to these issues will restore consumer confidence or increase the availability of credit. Our total revenues declined in 2009 compared to 2008 and the continued deterioration of the economy could have further adverse effects on the ability of existing and potential customers and suppliers to obtain financing for significant purchases and operations. These

factors could result in a decrease in, or cancellation of orders for our products and services. Our business can also be adversely affected by decreases in the general level of economic activity, such as decreases in defense spending, financial strength of customers and government procurement. We are unable to predict the duration and severity of the current disruption in financial markets and the adverse economic conditions that might occur and the effect such events might have on our business.

Our historical lack of earnings and continued future losses could adversely affect our financial health and prevent us from continuing to develop and market our products.

We have incurred net losses applicable to our common stockholders since our formation in June 2002. Our ability to achieve profitable operations is dependent upon, among other things, our ability to obtain sufficient government and commercial contracts, to complete the development of products based on our technologies and to control costs. We cannot assure you that we will be able to significantly increase our revenue or achieve and maintain profitability.

Our lack of earnings history and continued future losses could have important consequences, such as:

- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our flexibility in planning for, or reacting to, changes in our business and our industry;
- restricting us from introducing new products or exploiting business opportunities; or delaying or terminating research projects;
  - requiring us to sell debt or equity securities or to sell some of our core assets, possibly on unfavorable terms;
  - limiting our ability to obtain additional financing; and
- placing us at a possible competitive disadvantage compared to our competitors, who may have greater financial resources.

If we are unable to generate funds or obtain new funds on acceptable terms, we may not be able to continue to develop and/or market our present and potential products.

Our liquidity needs have typically arisen from the funding of our operating losses, our research and development program and the launch of our new products, working capital requirements, and strategic initiatives. In the past, we have met these cash requirements through proceeds from certain placements of our securities.

The development of products requires the commitment of substantial resources to conduct the time consuming research and development and regulatory activities necessary to bring any potential product to market and to establish production, marketing and sales capabilities. Our ability to fund our products, research and development, working capital and capital expenditures will depend on our future operating performance, which will be affected by factors discussed elsewhere in this filing and in the other reports we file with the SEC, including, without limitation, economic conditions and financial, business, regulatory, political, market and other factors, many of which are beyond our control.

Additionally, current economic conditions may inhibit our ability to obtain future funding from Government sources or from public capital sources consistent with our prior history.

We are limited in our ability to disclose significant details of our operations that may have a significant impact on our results and future operations due to restrictions imposed by our Government customers.

We produce military products and conduct research that is protected and deemed sensitive to the nation's security. Therefore, we are limited, under specific classification guides issued to the company by our government customers, in publicly discussing or disclosing certain details of our technologies, applications, contract terms and the product's future, if any. Such absence of explanation, detail and discussion may prohibit us from providing details that an investor may find meaningful, cause many individuals and investors to question our level of disclosure and discourage potential investors from investing in our securities.

The timing and magnitude of Government funding and orders for our CIED systems or products cannot be predicted.

We expect that we will be dependent upon sales of our CIED system products for a substantial portion of our revenue over the near future. We are hopeful that we will continue to receive funding to advance our technologies, however, the Government's course of action will not be fully known until orders for product are actually issued to us. Because Government agencies have been the dominant revenue source historically and many of these agencies continue to be identified as the intended customers for our various future products, it is uncertain whether we will enter into new or continue with existing development or production contracts and, if we do, what the timing or magnitude of such orders will be.

We may not be able to meet the volume or production demands for our CIED system products, if we receive production orders.

We intend to outsource certain manufacturing processes if our customers order a significant number of our CIED products. We are uncertain that we will be able to find sufficient outsource facilities to meet the customer's demands for our CIED products on a timely basis or at all. We are also pursuing teaming agreements and other formal arrangements with major defense contractors who have the facilities, resources and experience to support a sudden increase in demand for our CIED products. We cannot be certain that these agreements will be finalized in time to allow us to respond to a large order, or if we will be able to finalize those agreements at all. Failure to meet volume and production demands for any order we receive could result in the customer(s) seeking other sources for producing this product, and could limit the size of an order placed with us, or cause the customer(s) to choose not to place any orders with us.

The receipt of future Government funding is uncertain and may be reduced or eliminated at any time, particularly if our LIPC technology does not meet certain milestones.

We rely on Government funding for LIPC and LGE development through funding provided in the federal Government budget and contracts with various Government agencies. Due to federal budgetary constraints we cannot provide assurance that any continued Government funding will be made available, or that we will be able to enter into any agreements with Government customers for the further development of LIPC and LGE. We expect that additional funding for LIPC and LGE will be subject to our technology meeting certain Government established milestones. We have in the past missed some Government established milestones and schedule deadlines, and may do so again in the future. If our LIPC and LGE technology does not meet Government established milestones, due to our performance or outside environmental or physics constraints, additional Government funding may be reduced or eliminated. If additional Government funding for LIPC and LGE is reduced or is not forthcoming, in the absence of additional funding, our future LIPC and LGE technology development efforts could be terminated and our revenues would be adversely affected.

Our future success will depend on our ability to develop new technologies and applications that address the needs of our markets.

Both our defense and commercial markets are characterized by rapidly changing technologies and evolving industry standards. Accordingly, our future performance depends on a number of factors, including our ability to:

- identify emerging technological trends in our target markets;
- develop and maintain competitive products;
- enhance our products by improving performance and adding innovative features that differentiate our products from those of our competitors;
  - develop and manufacture and bring products to market quickly at cost-effective prices; and
- meet scheduled timetables and enter into suitable arrangements for the development, certification and delivery of new products and
  - enter into suitable arrangements for volume production of mature products.

We believe that, in order to remain competitive in the future, we will need to continue to develop new products, which will require the investment of significant financial and engineering resources. The need to make these expenditures could divert our attention and resources from other projects, and we cannot be sure that these expenditures will ultimately lead to the timely development of new technology, products, and systems using our technology or products. Due to the design complexity of our products, we may in the future experience delays in completing development and introduction of new products. Any delays could result in increased costs of development, deflect resources from other

projects or incur loss of contracts.

In addition, there can be no assurance that the market for our products will develop or continue to expand as we currently anticipate. The failure of our technology to gain market acceptance could significantly reduce our revenue and harm our business. Furthermore, we cannot be sure that our competitors will not develop competing or differing technologies which gain market acceptance in advance of our products. The possibility that our competitors might develop new technology or products might cause our existing technology and products to become obsolete or create significant price competition. If we fail in our new product development efforts or our products fail to achieve market acceptance more rapidly than our competitors, our revenue will decline and our business, financial condition and results of operations will be negatively affected.

Changes in government spending could significantly impact our sales and profitability.

Approximately 97% and 87%, of our net revenue for the years ended December 31, 2009 and 2008, respectively, were from the U.S. Government and Government contractors. U.S. defense spending historically has been cyclical. Though it is not clear that future defense spending will be equally cyclical, defense budgets rise when perceived threats to national security increase the level of concern over the country's safety. At other times, spending on the military can decrease. While Department of Defense funding has grown rapidly over the past few years, there is no assurance this trend will continue. Competing demands for federal funds can put pressure on all areas of spending, which could impact the defense budget.

A decrease in U.S. government defense spending or changes in spending allocation could result in one or more of our programs being reduced, delayed or terminated. Reductions in our existing programs, unless offset by other programs and opportunities, could adversely affect our ability to sustain and grow future sales and become profitable.

We depend on the Government for substantially all of our revenue, and a reduction in the quality of this relationship and/or a shift in Government funding could have severe consequences on our prospects and financial condition.

Any significant disruption or deterioration of our relationship with the Government or important agencies thereof could significantly reduce our revenue. Our Government programs must compete with programs managed by other defense contractors for a limited number of programs and for uncertain levels of funding. The development of our business will depend upon the continued willingness of the U.S. Government agencies to fund existing and new defense programs and, in particular, to continue to purchase our products and services. Although defense spending in the United States has increased in recent years, further increases may not continue and any proposed budget or supplemental budget request may not be approved. In addition, the U.S. Department of Defense may not continue to focus its spending on technologies or missions relevant to our technologies and products.

Our competitors continuously engage in efforts to expand their business relationships with the Government which may be to our disadvantage and are likely to continue these efforts in the future. The Government may choose to use other defense contractors for its limited number of defense programs. In addition, the funding of defense programs also competes with non-defense spending of the Government. Budget decisions made by the Government are outside of our control and have long-term consequences for the size and structure of Applied Energetics. A shift in Government defense spending to other programs in which we are not involved or a reduction in Government defense spending generally could have severe consequences for our results of operations.

Our Government customers may terminate or modify our existing contracts, which would adversely affect our revenue.

There are inherent risks in contracting with the Government, including risks peculiar to the defense industry, which could have a material adverse effect on our business, financial condition or results of operations. Laws and regulations permit the Government to:

- terminate contracts for its convenience;
- reduce or modify contracts if its requirements or budgetary constraints change;
- cancel multi-year contracts and related orders if funds for contract performance for any subsequent year become unavailable;
- shift its spending practices; and
- adjust contract costs and fees on the basis of audits done by its agencies.

If the Government terminates our contracts for convenience, we may only recover our costs incurred or committed for settlement expenses and profit on work completed before the termination. Additionally, most of our backlog could be adversely affected by any modification or termination of contracts with the Government or contracts the prime contractors have with the Government. The Government regularly reviews our costs and performance on its contracts, as well as our accounting and general business practices. The Government may reduce the reimbursement for our fees and contract-related costs as a result of an audit. We can give no assurance that one or more of our Government contracts will not be terminated under these circumstances. Also, we can give no assurance that we would be able to procure new Government contracts to offset the revenue lost as a result of any termination of our contracts. As our revenue is dependent on our procurement, performance and payment under our contracts, the loss of one or more critical contracts could have a negative impact on our financial condition.



Our business is subject to various restrictive laws and regulations because we are a contractor and subcontractor to the Government.

As a contractor and subcontractor to the Government, we are subject to various laws and regulations that are more restrictive than those applicable to non-Government contractors. We are required to obtain and maintain material Governmental authorizations and approvals to run our business as it is currently conducted. New or more stringent laws or Government regulations concerning Government contracts, if adopted and enacted, could have a material adverse effect on our business.

Generally, Government contracts are subject to oversight audits by Government representatives. Responding to Governmental audits, inquiries or investigations may involve significant expense and divert management attention from regular operations. Our Government business is also subject to specific procurement regulations and a variety of socio-economic and other requirements. These requirements, although customary in Government contracts, increase our performance and compliance costs. These costs might increase in the future, reducing our margins, which could have a negative effect on our financial condition. Failure to comply with these regulations and requirements could lead to suspension or debarment, for cause, from Government contracting or subcontracting for a period of time. Among the causes for debarment are violations of various statutes, including those related to:

- procurement integrity;
- export control;
- Government security regulations;
- employment practices;
- protection of the environment;
- accuracy of records and the recording of costs; and
- foreign corruption.

Any of these factors, which are largely beyond our control, could also negatively impact our financial condition. We also may experience problems associated with advanced designs required by the Government, which may result in unforeseen technological difficulties and cost overruns. Failure to overcome these technological difficulties and the occurrence of cost overruns would have a negative impact on our results.

These Government contracts may be subject to protest or challenge by unsuccessful bidders or to termination, reduction or modification in the event of changes in Government requirements, reductions in federal spending or other factors.

Competition within our markets may reduce our procurement of future contracts and our revenue.

The defense and commercial industries in which we operate are highly competitive. Our future competitors may range from highly resourceful small concerns, which engineer and produce specialized items, to large, diversified firms and defense contractors. Many of our potential competitors have more extensive or more specialized engineering, manufacturing and marketing capabilities and greater financial resources than we. Consequently, these competitors may be better suited to take advantage of economies of scale and devote greater resources to develop new technologies. There can be no assurance that we can continue to compete effectively with these firms. In addition, some of our suppliers and customers could develop the capability to manufacture products similar to products that we are developing. This would result in competing directly which could significantly reduce our revenue and seriously harm our business.

There can be no assurance that we will be able to compete successfully against our current or future competitors or that the competitive pressures we face will not result in reduced revenue and market share or seriously harm our

business.

We derive a substantial portion of our revenue from a limited number of contracts. Therefore, our revenue will be adversely affected if we fail to receive new contracts and renewals or follow-on contracts.

Our Government contracts are important because our contracts are typically for fixed terms which vary from shorter than one year to multi-year, particularly for contracts with options. The typical term of our contracts with the U.S. Government is between one and two years. The loss of revenue from our possible failure to obtain new contracts and renewals or follow-on contracts may be significant because our Government contracts account for a substantial portion of our revenue.

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Our products may fail to perform satisfactorily in tests or field operations and even if our products perform satisfactorily, there may be unanticipated delays in obtaining contracts.

Our Government customers typically test our products at various stages of development and through Operational Assessments. Our success will ultimately depend upon our products meeting performance criteria established by our customers. Failure of a product to perform satisfactorily in a field test or during operations could result in delay of product development, delay in production contracts, cost overruns or even termination of the contract, any of which could materially affect the development and manufacturing of such product and our prospects, revenue and financial condition.

We depend on component availability, subcontractor performance and our key suppliers to manufacture and deliver our products and services.

Our manufacturing operations are highly dependent upon the delivery of materials by outside suppliers in a timely manner. In addition, we depend in part upon subcontractors to assemble major components and subsystems used in our products in a timely and satisfactory manner. If these subcontractors are not willing to contract with us on competitive terms or devote adequate resources to fulfill their obligations to us, or we do not properly manage these relationships, our existing customer relationships may suffer. In addition, by undertaking these activities, we run the risks that:

- the reputation and competitiveness of our products and services may deteriorate as a result of the reduction of our control over quality and delivery schedules and the consequent risk that we will experience supply interruptions and be subject to escalating costs; and
- our competitiveness may be harmed by the failure of our subcontractors to develop, implement or maintain manufacturing methods appropriate for our products and customers.

Moreover, because most of our contracts are with Governmental agencies, we may be limited in the third parties we can engage as component manufacturers due to security clearance requirements.

We are dependent for some purposes or product on sole-source suppliers. If any of these sole-source suppliers fails to meet our needs, we may not have readily available alternatives. Our inability to fill our supply needs could jeopardize our ability to satisfactorily and timely complete our obligations under Government and other contracts. This might result in reduced revenue, termination of one or more of these contracts and damage to our reputation and relationships with our customers. We cannot be sure that materials, components, and subsystems will be available in the quantities we require, if at all.

Because the manufacturing process of our products is highly complex, errors, changes or uncertainties could disrupt production.

The manufacture of our products involves highly complex and precise processes, requiring production in a highly controlled environment. Inadvertent or slight changes or uncertainties in our manufacturing processes, errors or use of defective or contaminated materials could impact our ability to achieve and affect product reliability, or disrupt and/or delay production.

Our business could be adversely affected by a negative audit by the U.S. Government.

Government agencies such as the Defense Contract Audit Agency ("DCAA") routinely audit and investigate Government contractors. These agencies review a contractor's performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. The DCAA also reviews the adequacy of, and a

contractor's compliance with, its internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. If an audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the Government. In addition, our reputation would suffer serious harm if allegations of impropriety were made against us.

Our backlog is subject to reduction and cancellation.

Backlog represents products or services that our customers have committed by contract to purchase from us. Our total funded backlog as of December 31, 2009 and February 28, 2010 was approximately \$3.4 million and \$11.6 million, respectively. Backlog is subject to fluctuations and is not necessarily indicative of future revenue. Moreover, cancellations of purchase orders or reductions of product quantities in existing contracts could substantially and materially reduce backlog and, consequently, future revenue. Our failure to replace cancelled or reduced backlog could result in lower future revenue.

We depend on the recruitment and retention of qualified personnel, and failure to attract and retain such personnel could seriously harm our business.

Due to the specialized nature of our businesses, our future performance is highly dependent upon the continued services of our key engineering and scientific personnel. Our prospects depend upon our ability to attract and retain qualified engineering, scientific and manufacturing personnel for our operations. Competition for personnel is intense, and we may not be successful in attracting or retaining qualified personnel. Our failure to compete for these personnel could seriously harm our business, results of operations and financial condition. Additionally, since the majority of our business involves technologies that are classified due to national security reasons, we must hire U.S. Citizens who have the ability to obtain a security clearance. This further reduces our potential labor pool.

Because many of our contracts and projects are classified for national security reasons, we may not be able to provide important information to the public.

To date, a majority of our revenue has been derived from contracts which are classified by the Government for national security reasons. Therefore, we are prohibited from filing these contracts as exhibits to our SEC reports, registration statements and filings or provide more than the summary information that we provide in our reports, registration statements and other filings with the SEC and in our press releases. The specific aspects of our technologies are highly sensitive to ongoing military operations and are largely classified under specific Department of Defense guidelines and, consequently, cannot be disclosed publicly. Accordingly, investors may not have important information concerning our businesses and operations with which to make an informed investment decision.

The U.S. Government's royalty-free right to use technology developed by us limits our intellectual property rights.

We seek to protect the competitive benefits we derive from our patents, proprietary information and other intellectual property. However, we do not have the right to prohibit the U.S. Government from using certain technologies developed or acquired by us or to prohibit third party companies, including our competitors, from using those technologies in providing products and services to the U.S. Government. The U.S. Government has the right to royalty-free use of technologies that we have developed under Government contracts. We are free to commercially exploit those Government-funded technologies and may assert our intellectual property rights to seek to block other non-Government users thereof, but we cannot assure you we could successfully do so.

We are subject to Government regulation which may require us to obtain additional licenses and could limit our ability to sell our products outside the United States.

We may be unable to adequately protect our intellectual property rights, which could affect our ability to compete.

Protecting our intellectual property rights is critical to our ability to compete and succeed as a company. We hold a number of United States patents and patent applications, as well as trademark, and registrations which are necessary and contribute significantly to the preservation of our competitive position in the market. There can be no assurance that any of these patents or future patent applications and other intellectual property will not be challenged, invalidated or circumvented by third parties. In some instances, we have augmented our technology base by licensing the proprietary intellectual property of others. In the future, we may not be able to obtain necessary licenses on commercially reasonable terms. We enter into confidentiality and invention assignment agreements with our employees, and enter into nondisclosure agreements with our suppliers and appropriate customers so as to limit access to and disclosure of our proprietary information. These measures may not suffice to deter misappropriation or independent third party development of similar technologies. Moreover, the protection provided to our intellectual property by the laws and courts of foreign nations may not be as advantageous to us as the remedies available under United States law.

We may face claims of infringement of proprietary rights.

There is a risk that a third party may claim our products infringe on their proprietary rights. Whether or not our products infringe on proprietary rights of third parties, infringement or invalidity claims may be asserted or prosecuted against us and we could incur significant expense in defending them. If any claims or actions are asserted against us, we may be required to modify our products or obtain licenses on commercially reasonable terms, which we may be unable to do in a timely manner or at all. Our failure to do so could adversely affect our business.

Our operations expose us to the risk of material environmental liabilities.

We are also subject to increasingly stringent laws and regulations that impose strict requirements for the proper management, treatment, storage and disposal of hazardous substances and wastes, restrict air and water emissions from our testing and manufacturing operations, and require maintenance of a safe workplace. These laws and regulations can impose substantial fines and criminal sanctions for violations, and require the installation of costly pollution control equipment or operational changes to limit pollution emissions and/or decrease the likelihood of accidental hazardous substance releases. We incur, and expect to continue to incur, capital and operating costs to comply with these laws and regulations. In addition, new laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination or the imposition of new clean-up requirements could require us to incur costs in the future that would have a negative effect on our financial condition or results of operations.

The unpredictability of our results may harm the trading price of our securities, or contribute to volatility.

Our operating results may vary significantly over time for a variety of reasons, many of which are outside of our control, and any of which may harm our business. The value of our securities may fluctuate as a result of considerations that are difficult to forecast, such as:

- the size and timing of contract receipt and funding; changes in Government policies and Government budgetary policies;
  - termination or expiration of a key Government contract;
- our ability and the ability of our key suppliers to respond to changes in customer orders;
- timing of our new product introductions and the new product introductions of our competitors;
  - adoption of new technologies and industry standards;
- competitive factors, including pricing, availability and demand for competing products, and fluctuations in foreign currency exchange rates;
  - conditions in the capital markets and the availability of project financing;
- the ability to hire and retain key scientists and executives and/or appropriately trained and experienced staff;
  - regulatory developments;
  - general economic conditions;
  - changes in the mix of our products;
  - cost and availability of components and subsystems; and
  - price erosion.

Our stock is subject to the risk of being de-listed from the NASDAQ Stock Market.

On September 17, 2009, we received notice that we were not in compliance with Marketplace Rule 5450(a)(2), which requires a minimum \$1.00 closing bid price for common stock. The company's common stock closing bid had dropped below, and remained below this required threshold. On March 3, 2010, our common stock was transferred to the NASDAQ Capital Market as a result of our failure to meet the \$1.00 minimum bid requirement. As of the date of this report, our common stock bid price remains below \$1.00. If the closing bid price of our common stock does not meet or exceed \$1.00 per share for at least 10 consecutive business days, we may be de-listed from the NASDAQ stock market in the future. Any such delisting could adversely affect the liquidity or market pricing of our stock.

A large number of shares of our common stock could be sold in the market in the near future, which could depress our stock price.

As of March 12, 2010, we had outstanding approximately 89 million shares of common stock. A substantial portion of our shares are currently freely trading without restriction under the Securities Act of 1933, having been held by their holders for over one year and are eligible for sale under Rule 144(k) of the Securities Act. Our outstanding Series A Preferred Stock is convertible into an aggregate of 282,444 shares of common stock. There are also currently outstanding restricted stock, restricted stock units, options and warrants to purchase approximately 6.0 million shares of our common stock. To the extent any of our options or warrants are exercised or the shares of Series A Preferred Stock are converted, the percentage ownership of holders of our common stock will be diluted and our stock price could be further adversely affected. The shares of common stock underlying the Series A Preferred Stock and outstanding restricted stock, restricted stock units, options and warrants have been registered for resale by the holders thereof or are eligible for sale under Rule 144. As the underlying shares are sold, the market price could drop significantly if the holders of these restricted shares sell them or if the market perceives that the holders intend to sell these shares.



There are many factors outside of our control which could adversely affect the price of our stock or the ability to sell our shares.

There are many financial, political, regulatory and market factors and other third-party actions that influence the trading and pricing of our securities. Many of these are outside our control. Such factors, actions or activities could negatively impact your ability to trade your shares, the price of your shares, or could further negatively impact our ability to utilize public equity markets according to the needs and optimal timing of offerings, acquisitions, infusions or liquidity.

Provisions of our corporate charter documents could delay or prevent change of control.

Our Certificate of Incorporation authorizes our Board of Directors to issue up to 1,000,000 shares of "blank check" preferred stock without stockholder approval, in one or more series and to fix the dividend rights, terms, conversion rights, voting rights, redemption rights and terms, liquidation preferences, and any other rights, preferences, privileges, and restrictions applicable to each new series of preferred stock. In addition, our Certificate of Incorporation divides our board of directors into three classes, serving staggered three-year terms. At least two annual meetings, instead of one, will be required to effect a change in a majority of our board of directors. The designation of preferred stock in the future, the classification of our Board of Directors, its three classes and the rights agreement could make it difficult for third parties to gain control of our company, prevent or substantially delay a change in control, discourage bids for our common stock at a premium, or otherwise adversely affect the market price of our common stock.

We use estimates in accounting for many of our programs and changes in our estimates could adversely affect our future financial results.

Contract accounting requires judgments relating to assessing risks, including risks associated with customer directed delays and reductions in scheduled deliveries, unfavorable resolutions of claims and contractual matters, judgments associated with estimating contract revenues and costs, and assumptions for schedule and technical issues. The estimation of total revenues and cost at completion is complicated and subject to many variables. Because of the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if we used different assumptions or if the underlying circumstances were to change. Changes in underlying assumptions, circumstances or estimates may adversely affect our future results of operations and financial condition, including requiring us to take write downs or charges in certain periods, and could result in fluctuations in our operating results.

Our investment in cash and cash equivalents are subject to risks, including risks relating to the banks in which these assets are held.

At December 31, 2009, we had \$44,000 of cash and \$225,000 in a certificate of deposit held primarily in two large banks which are FDIC insured to FDIC limits. In addition, we had \$9.6 million invested in money market funds that primarily invest in government and US treasury based securities.

If we fail to maintain compliance with applicable NASDAQ Rules and our stock is delisted from the NASDAQ StockMarket, it may become subject to Penny Stock Regulations and there will be less interest for our stock in the market.

If our stock is not listed on NASDAQ and fails to maintain a price of \$5.00 or more per share, our stock would become subject to the Securities and Exchange Commission's "Penny Stock" rules. These rules require a broker to deliver, prior to any transaction involving a Penny Stock, a disclosure schedule explaining the Penny Stock Market

and its risks. Additionally, broker/dealers who recommend Penny Stocks to persons other than established customers and accredited investors must make a special written suitability determination and receive the purchaser's written agreement to a transaction prior to the sale. If our common stock becomes subject to these rules, broker-dealers may find it difficult to effectuate customer transactions and trading activity in our securities may be adversely affected. As a result, the market price of our securities may be depressed and security holders may find it more difficult to sell their securities.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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## ITEM 2. PROPERTIES

Our principal office, manufacturing, storage, and primary research and development facility is located in Tucson, Arizona. We purchased this approximately 25,000 square foot facility in February, 2008.

In November of 2009, we entered into a lease agreement for 20,000 square feet of office and light manufacturing space in Tucson, Arizona for a period of two years at a monthly rent of approximately \$9,000. Concurrently we vacated two other leased facilities. We also vacated a leased facility in Tucson in January of 2010. This has allowed us to consolidate operations for efficiency and reduce associated utility, rent and insurance costs.

In December of 2006, we entered into a lease agreement for an additional 12,000 square foot facility in Tucson, Arizona, and we exercised our option to extend this lease to January 2010 with monthly rent of approximately \$7,000, accelerating to approximately \$7,400 in the final year of the lease. We have vacated this property and our last lease payment was in January, 2010.

Our aggregate rent expense, including common area maintenance costs, was approximately \$390,000 and \$457,000 for 2009 and 2008, respectively.

We believe our facilities are adequate for our current planned operations.

See Note 10 to the Consolidated Financial Statements of our 2009 Financial Statements, which is incorporated herein by reference for information with respect to our lease commitments at December 31, 2009.

## ITEM 3. LEGAL PROCEEDINGS

Except as described in Notes 10 and 14 to the Consolidated Financial Statements, which is incorporated herein by reference, as of December 31, 2009, we were not a party to any pending legal proceedings other than claims that arise in the conduct of our business.

## ITEM 4. RESERVED

## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASE OF EQUITY SECURITIES

## Market price per share

Our common stock is currently listed on the NASDAQ Global Market, trading under the symbol "AERG." The following table sets forth information as to the price range of our common stock for the period January 1, 2008 through December 31, 2009. No dividends on common stock were declared for these periods.

| Quarterly Periods | High    | Low     |
|-------------------|---------|---------|
| 2008              |         |         |
| First             | \$ 3.25 | \$ 1.58 |
| Second            | 2.94    | 1.59    |
| Third             | 2.00    | 0.52    |
| Fourth            | 1.00    | 0.18    |
| 2009              |         |         |
| First             | 0.43    | 0.16    |
| Second            | 0.69    | 0.22    |
| Third             | 0.60    | 0.33    |
| Fourth            | 0.54    | 0.25    |

## Holders of Record

As of March 12, 2010, there were approximately 240 holders of record of Applied Energetics' common stock.

## Unregistered Sale of Securities and Use of Proceeds

There were no unregistered sales of securities in 2009.

## Dividends

We have never paid cash dividends on our common stock and do not expect to do so in the foreseeable future. Instead, we intend to retain any earnings to support our operations and the growth of our business.

Dividends on our Preferred Stock are payable quarterly on the first day of February, May, August and November, in cash or shares of Common Stock, at our discretion. We declared and paid dividends on our 6.5% Series A Convertible Preferred Stock in May, August and November, 2009 and February, 2010. Portions of these dividends were paid in the form of common stock with the remaining paid in cash. Cash dividends on Preferred Stock are accrued when the amount of the dividend is declared. In 2008, 5,151,000 shares of common stock were exchanged for 515,100 shares of preferred stock. Such exchange was determined to be an induced conversion and, as such, required \$3.3 million to be reported as a special dividend.

## Equity Compensation Plan Information

See Item 12.



In 2009, the company purchased 112,762 shares of common stock from employees to satisfy the company's withholding tax requirements. Such purchases in the form of a net issuance occurred as follows:

| Period     | Issuer Purchases of Equity Securities                         |  |   |   |
|------------|---|--|---|---|
|            | (a)<br>Total number<br>of Shares (or<br>Units)<br>Surrendered | (b)<br>Average<br>Price Paid<br>per Share<br>(or Unit) | (c)<br>Total Number of<br>Shares (or Units)<br>Purchased as<br>Part of Publicly<br>Announced Plans<br>or Programs | (d)<br>Maximum Number (or<br>Approximate Dollar<br>Value) of Shares (or<br>Units) that May Yet Be<br>Purchased Under the<br>Plans or Programs |
| Jan. 2009  | 39,698  | \$ 0.25  | 39,698  | Undetermined  |
| Apr. 2009  | 3,620   | \$ 0.50  | 3,620   | Undetermined  |
| Sept. 2009 | 69,444  | \$ 0.48  | 69,444  | Undetermined  |

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

You should read the following management discussion and analysis ("MD&A") together with the risk factors set forth in Item 1A., and with our audited Consolidated Financial Statements and Notes thereto included elsewhere herein.

### Overview

Applied Energetics is a leader in the development and manufacture of applied energy systems for military and commercial applications. Through our efforts in developing our core technology, Laser Guided Energy (LGE), we have gained expertise and proprietary knowledge in high performance lasers, high-voltage electronics, advanced dynamic optics and atmospheric and plasma interactions. We apply these technologies to deliver innovative solutions to urgent military requirements, including neutralizing improvised explosive devices ("IEDs") and other high priority missions of U.S. and allied military forces. Additionally, we develop and manufacture high-voltage and laser products for government and commercial customers for a range of applications. Applied Energetics was founded on the premise that an entrepreneurial approach to technology development would accelerate the advancement of Laser Guided Energy (LGE) to solve critical needs in the Directed Energy Weapon arena. We have developed an effective and robust counter-IED technology as a result of our research and development.

### LGETM and LIPC® Technologies:

Applied Energetics is the developer of LGE and laser induced plasma channel ("LIPC®") technologies. These revolutionary technologies can precisely deliver high voltage electrical charges by using a laser to create a conductive path in the atmosphere. We are developing applications that can deliver tailored weapon and countermeasure effects to targets with laser accuracy, and with manageable effects to reduce the potential for inadvertent injury and minimize collateral damage. This technology has been in development since our inception in 2002, and we have protected what we believe to be the enabling intellectual property through U.S. Patent filings. LGE development has been funded through multiple Department of Defense contracts in support of U.S. Navy, Army, Air Force, and the Office of Secretary of Defense programs as well as through internally funded research initiatives.

On August 18, 2009, we received a \$3.1 million contract from the U.S. Army's Research, Development and Engineering Command for the continued advancement and development of our LGE technology. The contract is for a period of three years, with a potential contract ceiling of \$13.4 million.

Counter-IED Technologies:

Working with the United States Marine Corps, we have developed and delivered a system that demonstrates significant capability in countering IEDs, a major threat to military operations throughout the world. Technical and field results of such CIED technologies are highly sensitive or classified, but we are satisfied that our technology has performed well in addressing this critical mission. We have integrated our CIED technologies into military vehicles. We anticipate additional product variations may be utilized on other military platforms in the future as military customers identify new mission areas for implementation of our technologies. We continue to work actively with our customers to field these innovative CIED technologies.

During 2009, our focus was on completing work on a \$9.5 million contract, which included additional funding through contract modifications for our U.S. Marine Corps program for approximately \$476,000, of which \$224,000 was received in September. Additionally, we received \$230,000 in continued funding in November of 2009 to support further development and operational assessment of the technology. In January 2010, we received a \$10.4 million contract increase to continue further Operational Assessment of the technology, develop additional systems, provide training and field support for systems, develop a smaller version of the technology for installation on other U.S. Marine Corps and U.S. Army vehicles and platforms, and to upgrade the engineering documentation of the system to facilitate future transition to Low Rate Initial Production.

Our counter-IED technology continues to perform well and has received favorable evaluations by the U.S. Marine Corps. The delivery and successful employment of this technology by a customer in a rugged field environment is an important milestone for Applied Energetics, as we believe it validates our ability to transition technologies from the laboratory to the field and provide customer support throughout the product life cycle. In late January 2010, the Commanding General of the Marine Corps Systems Command (MCSC) made the decision to begin transitioning this program from the Marine Corps Warfighting Laboratory to MCSC for program oversight and further development. Applied Energetics was informed that its technology would become part of an existing Program of Record for Ground Support Equipment for Combat Engineers within the Marine Corps. This group is responsible for counter-IED operations for the Marines. This decision is another significant milestone for the company, as this transition is the first indication that one of our technologies is expected to be produced for regular military procurement as opposed to developmental activities. Furthermore, we believe that the acceptance of this technology by a military customer will have a positive effect on development activities for LGE for use of that technology for additional counter-IED missions.

In preparation for the transition of our counter-IED technology to regular production, Applied Energetics has entered into discussions with large defense contractors to investigate teaming agreements or other arrangements to enable us to rapidly increase production rates while focusing on the areas that are within our core areas of expertise. Such arrangements would take advantage of the scale and resources that these organizations possess, along with their considerable experience and reputation in delivering certified products to military customers. It is expected that Applied Energetics would maintain the position of prime contractor for these future production contractors, with the other organizations acting as subcontractors within their areas of expertise.

#### High-Voltage Technologies:

Since the company's inception, it has acquired and developed unique high-voltage capabilities. Operating within the company is a group focused on providing customized high-voltage solutions for semiconductor, aerospace, chemical processing, and other military and commercial activities. Opportunities currently in process or under development include advanced electron-beam technologies, nested high-voltage generators and other unique power solutions for a wide range of applications.

During 2009, we delivered several High Voltage products to commercial customers. We also received an order for development of an electron beam system that uses our nested high voltage generator as a power source for delivery in the second quarter of 2010. While the dollar value of these contracts are relatively small compared to the multi-million dollar government contracts for counter-IED and LGE, we believe that these continuing orders will allow us to build expertise and markets within the commercial sector for our high voltage technologies and systems.

#### Laser Technologies

The company has the capability to design and build rugged solid state lasers and unique laser components for military and commercial applications. The company has the expertise to build very unique, rugged ultra-short pulse lasers for



key applications.

On July 30, 2009, we received a \$992,000 contract for the design, development and delivery of a laser system to the U.S. Navy.

#### Emerging Markets and Applications

In the third quarter of 2009, we initiated a new strategic plan. The objective of this effort was to identify the areas in which our core strengths can be developed to increase our business across new applications in the military, government and commercial sectors. The goals for the strategic plan include increasing revenues, achieving positive cash flow, profitability, development of new products and markets, and controlling costs to improve margins.

## Critical Accounting Policies

### Use of Estimates

The preparation of consolidated financial statements in conformity with United States generally accepted accounting principles requires management to make estimates, judgments and assumptions that affect the amounts reported in the financial statements and accompanying notes. Management bases its assumptions on historical experiences and on various other inputs and estimates that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. In addition, management considers the basis and methodology used in developing and selecting these estimates, the trends in and amounts of these estimates, specific matters affecting the amount of and changes in these estimates, and any other relevant matters related to these estimates, including significant issues concerning accounting principles and financial statement presentation. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein. Significant estimates include revenue recognition under the percentage of completion method of contract accounting, estimate to forecast loss on contracts under the completed contract method of accounting, the valuation of inventory, estimates of long-lived asset value, and estimate to forecast expected forfeiture rate on stock-based compensation and stock-based compensation expense.

### Revenue Recognition

Revenue has been derived from ongoing contract work for systems development, effects testing and the design and development of demonstration systems and sub-systems for our Government and commercial customers. This work is expected to be generally performed under cost-plus contracts with Government customers.

Revenue under long-term Government contracts is generally recorded under the percentage of completion method. Revenue, billable monthly, under cost plus fixed fee contracts is recorded as costs are incurred and includes estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. Costs include direct labor, direct materials, subcontractor costs and overhead. General and administrative expenses allowable under the terms of the contracts are allocated per contract depending on its direct labor and material proportion to total direct labor and material of all contracts. As contracts can extend over one or more accounting periods, revisions in earnings estimated during the course of work are reflected during the accounting period in which the facts become known. When the current contract estimate indicates a loss, a provision is made for the total anticipated loss in the period in which the facts become known. Management evaluates many variables and makes various assumptions related to the estimation of total cost of completion of long-term contracts. Management reviews the progress and performance of all contracts monthly.

The asset caption "accounts receivable" includes costs and estimated earnings in excess of billings on uncompleted contracts, which represents revenue recognized in excess of amounts billed. Such revenue is billable under the terms of the contracts at the end of the year, yet was not invoiced until January, 2010, and is generally expected to be collected within one year. The liability "billings in excess of costs and estimated earnings on uncompleted contracts" represents billings in excess of revenue recognized.

Revenue for other products and services is recognized when such products and services are delivered or performed and, in connection with certain sales to certain customers, when the products and services are accepted, which is normally negotiated as part of the initial contract. Revenue from commercial, non-Governmental customers has historically been based on fixed price contracts where the sale is recognized upon acceptance of the product or performance of the service and when payment is probable under the completed contract method of accounting. Contract costs are accumulated in the same manner as inventory costs and are charged to operations as the related

revenue from contract is recognized. When the current contract estimate indicates a loss, a provision is made for the total anticipated loss in the period in which the facts become known.

#### Inventories

Inventories include material, direct labor and related manufacturing administrative overhead and are stated at the lower-of-cost (determined on a weighted average basis) or market for raw materials and work-in-process inventory. When actual contract cost and the estimate to complete exceed the estimated contract revenues, a loss provision is recorded. Due to the nature of our inventory, we analyze inventory on an item-by-item basis compared to future usage and sales for obsolescence quarterly.

#### Share-Based Payments

Stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period.

The fair value of each option grant is estimated at the date of grant using the Black-Scholes option valuation model. We make the following assumptions relative to this model: (i) the annual dividend yield is zero as we do not pay dividends, (ii) the weighted-average expected life is based on historical share option exercises, pre and post vesting terminations and share option term expiration, (iii) the risk free interest rate is based on the U.S. Treasury security rate for the expected life, and (iv) the volatility is based on the level of fluctuations in our historical share price for a period equal to the weighted-average expected life. We estimate forfeitures when recognizing compensation expense and adjust this estimate over the requisite service period should actual forfeitures differ from such estimates. Changes in estimated forfeitures are recognized through a cumulative adjustment, which is recognized in the period of change and which impacts the amount of unamortized compensation expense to be recognized in future periods.

## Results of Operations

Our consolidated financial information for the years ending December 31, 2009, and 2008 is as follows:

|  | 2009           | 2008           |
|--|----------------|----------------|
| Revenue                                | \$ 7,459,808   | \$ 16,614,211  |
| Cost of revenue                        | 7,007,923      | 15,874,818     |
| General and administrative             | 6,795,972      | 8,470,656      |
| Settlement expenses                    | 1,337,409      | -              |
| Selling and marketing                  | 631,578        | 251,349        |
| Research and development               | 1,182,652      | 1,372,396      |
| Other (expense) income:                |                |                |
| Interest expense                       | (1,131)        | (2,099)        |
| Interest income                        | 60,562         | 637,475        |
| Other income                           | -              | 10             |
| Loss before provision for income taxes | (9,436,295)    | (8,719,622)    |
| Provision (benefit) for income taxes   | -              | -              |
| Net loss                               | \$ (9,436,295) | \$ (8,719,622) |

## Revenue

Revenue decreased approximately \$9.2 million to \$7.5 million for the year ended December 31, 2009 compared to 2008. Our Counter-IED revenue decreased by \$4.7 million to \$2.4 million in 2009 due to revenues being derived mostly from operational support and testing of our Counter-IED systems compared to manufacturing of Counter-IED systems and spares in 2008. LGE revenues decreased by \$2.8 million to \$4.4 million in 2009 mostly attributable to ending of certain LGE contracts in the first half of 2009 and then increasing in the second half of 2009 with the announcement of two new contracts. High Voltage revenue decreased by \$2.0 million in 2009 to \$250,000 due to reduced hardware sales in the commercial markets. Laser revenues, a new product line, increased by \$300,000.

## Cost of Revenue

Cost of revenue includes manufacturing labor, benefits and overhead, and an allocation of allowable general and administration and research and development costs in accordance with the terms of our government contracts.

Cost of revenue for 2009 decreased by \$8.9 million for the year ended December 31, 2009 compared to 2008. The decrease in cost of revenue directly tied to the decrease in sales activity, and to a lower-of-cost-or-market inventory adjustment of \$0.5 million and loss provisions of approximately \$0.2 million that occurred in 2008. By product line, Counter-IED costs decreased by approximately \$4.9 million, LGE costs decreased by approximately \$2.5 million, High Voltage costs decreased by \$1.8 million, and were offset by an increase in Laser costs of approximately \$0.3

million.

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### General and Administrative

G&A expenses decreased approximately \$1.7 million for the year ended December 31, 2009 compared to 2008. The decrease in G&A expenses was primarily driven by the decision to right size the company in terms of both employees and cost reduction initiatives based on a shortfall of revenue, which became evident in the second quarter of 2009. Salaries and wages decreased by approximately \$2.1 million, non-cash compensation costs decreased by approximately \$1.9 million, supplies and building related expenses decreased by approximately \$300,000, travel expenses decreased by approximately \$280,000, relocation expenses decreased by approximately \$312,000, depreciation expenses decreased by approximately \$235,000 and professional services decreased by \$141,000. The decreases in expenses were offset by a decrease in applied labor, overhead and material handling costs allocated to cost of revenue of approximately \$3.4 million and to asset disposals associated with leasehold improvement of approximately \$153,000.

At December 31, 2009, there were approximately \$335,000 of unrecognized compensation costs related to unvested restricted stock awards, net of estimated forfeitures and approximately \$255,000 of unrecognized compensation costs related to unvested stock options, net of estimated forfeitures. These costs are expected to be recognized on a weighted-average basis over periods of approximately one year for restricted stock awards and two years for unvested stock options.

### Litigation Settlement

Litigation settlement expenses for 2009 were approximately \$1.3 million. This includes the fair value of the 2,283,887 shares issued in settlement of the class action lawsuit filed by George Wood and Raymond Deedon, and the derivative action filed by John T. Johnasen on September 29, 2009, and the legal fees not covered by insurance proceeds.

### Selling and Marketing

Selling and marketing expenses increased by approximately \$380,000 for the year ended December 31, 2009 compared to 2008. The increase was mostly due to increases in labor allocation and travel related to business development, and bids and proposals activities that enabled new contracts aggregating approximately \$6.2 million for 2009 tied to LGE contracts and a \$10.4 million contract received in January 2010.

### Research and Development

Research and development expenses decreased approximately \$190,000 for the year ended December 31, 2009 compared to 2008. Our internal research and development costs involve experimentation, design, development and enhancement of proprietary technologies and new products.

### Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Net interest income for 2009 was lower by approximately \$577,000 from 2008 primarily due to the lower balance of invested funds and lower interest rates in 2009.

### Net Loss

Our operations in 2009 resulted in a net loss of approximately \$9.4 million, an increase of approximately \$700,000 when compared to the approximately \$8.7 million net loss for 2008. Our net loss attributable to common stockholders

per common share – basic and diluted decreased from \$0.16 per share to \$0.11 per share, partially due to the increased number of shares outstanding in 2009.

#### Inflation and Seasonality

We do not believe that inflation has a material effect on the operations or financial condition of our business, nor do we believe that we are subject to significant seasonal swings in our business.

## Liquidity and Capital Resources

At December 31, 2009, we had approximately \$9.6 million of cash and cash equivalents, and \$225,000 in a certificate of deposit. In 2009, we used approximately \$5.5 million of cash in operating activities. This amount is comprised primarily of our net loss of approximately \$9.4 million, increases in inventories of \$600,000, due to a new contract, and decreases in accounts payable and other accrued expenses of approximately \$700,000. Offsetting these amounts were non-cash stock option compensation expense of approximately \$1.8 million, a decrease in accounts receivable of approximately \$1.7 million, litigation costs paid in common stock of approximately \$1.1 million and depreciation and amortization of approximately \$600,000. Also in 2009, investing activities used approximately \$45,000 and financing activities used approximately \$131,000.

We anticipate that short-term and long-term funding needs will be provided from the cash flow from servicing our Government contracts. We believe that we have sufficient working capital to fulfill existing contracts and expected contracts in 2010 and into 2011. The Government contracts, that presently represent a major portion of our current activity, are on a cost plus fixed fee basis. This means all work performed is done at our Government-approved rates, which include general and administrative costs, overhead, labor and materials, fees and profit. These costs are accrued as incurred and billed monthly.

## Backlog

At December 31, 2009 and 2008, respectively, we had a backlog (i.e. work load remaining on signed contracts) of approximately \$3.4 million, and \$4.6 million, respectively, to be completed within the twelve months following those dates. As of February 28, 2010, our backlog was \$11.6 million.

## Operating Leases

We generally operate in leased premises under operating leases that have options permitting renewals for additional periods. Total rent expense on premises amounted to approximately \$390,000, and \$457,000 for 2009 and 2008, respectively. In February 2008, we purchased our principal office, manufacturing, storage, and primary research and development facility in Tucson, Arizona for approximately \$2.2 million.

## Preferred Stock

The Series A Preferred Stock has a liquidation preference of \$25.00 per share. The Series A Preferred Stock bears dividends at the rate of 6.5% of the liquidation preference per share per annum, which accrues from the date of issuance, and is payable quarterly, when declared. Dividends are payable in: (i) cash, (ii) shares of our common stock (valued for such purpose at 95% of the weighted average of the last sales prices of our common stock for each of the trading days in the ten trading day period ending on the third trading day prior to the applicable dividend payment date), provided that the issuance and/or resale of all such shares of our common stock are then covered by an effective registration statement or (iii) any combination of the foregoing. As of December 31, 2009, there were 135,572 shares of Series A Preferred Stock outstanding.

## Recent Accounting Pronouncements

Refer to Note 2 of Notes to Consolidated Financial Statements for a discussion of recent accounting standards and pronouncements.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA



Our financial statements, the related notes and the Report of Independent Registered Public Accounting Firm thereon, are included in Applied Energetics' 2009 Financial Statements and are filed as a part of this report on page F-1 following the signatures.

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

There were no changes in or disagreements with accountants on accounting and financial disclosure matters.

## ITEM 9A(T). CONTROLS AND PROCEDURES

### Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Our management, with the participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2009. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on that evaluation our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures are effective.

### Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act. Internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officers and affected by our Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the company's assets;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of the management and directors of the company; and
  - Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management, including our Principal Executive Officer and Principal Financial Officer, has conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2009, based on the framework established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Framework). This assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of those controls. Based on our assessment under the criteria described above, management has concluded that our internal control over

financial reporting was effective as of December 31, 2009.

This Annual Report on Form 10-K does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this Annual Report on Form 10-K.

#### Changes in Internal Control Over Financial Reporting

There has been no change in Applied Energetics' internal control over financial reporting for the quarter ended December 31, 2009 that materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

## PART III

## ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The following is information with respect to our executive officers and directors:

| Name                   | Age | Principal Position   | Director,<br>Term<br>expiring in |
|------------------------|-----|--|----------------------------------|
| James M. Feigley       | 60  | Chairman of the Board  | 2012                             |
| Joseph C. Hayden       | 51  | Chief Operating Officer and<br>principal executive officer                     |                                  |
| Humberto A.<br>Astorga | 37  | Controller, principal financial<br>officer and principal accounting<br>officer |                                  |
| David C. Hurley        | 69  | Independent Director   | 2010                             |
| George P. Farley       | 71  | Independent Director   | 2012                             |
| James K. Harlan        | 58  | Independent Director   | 2010                             |
| John F. Levy           | 54  | Independent Director   | 2011                             |
| Mark J. Lister         | 52  | Independent Director   | 2011                             |

**James M. Feigley:** James M. Feigley has served as a member of our Board of Directors since June 2008, and as Chairman since April of 2009. Mr. Feigley serves as a member of our Nominating and Governance Committee and our Strategic Planning Committee. Mr. Feigley has served as President of Rock River Consulting, Inc., a defense consulting firm he founded in May 2003 after retiring from the U.S. Marine Corps. General Feigley served as Commander of the Marine Corps Systems Command from 1998 through 2002, where he was the executive authority on research, development, procurement, fielding and life cycle support for all Marine Corps ground combat, combat support and combat service support equipment, ordinance and systems. General Feigley served as Direct Reporting Program Manager to the Assistant Secretary of the Navy, Research, Development and Acquisition Program from 1993 through 1998, during which time he was in charge of business planning, cost estimating, technical risk analyses and management, systems engineering and numerous other responsibilities. He served as Project Manager for the Headquarters, U.S. Marine Corps and Naval Sea Systems Command from 1986 through 1993, where he managed all technology base projects for 'Advanced Amphibious Assault Vehicle' and wrote all technical, financial, cost, management, risk, planning and performance documentation. General Feigley served as a member of the United States Marine Corps from 1972 through 2002. He received a BS from the University of Wisconsin - Oshkosh in 1972 and graduated from the Army Logistics Management Center in 1982, the Marine Corps Command and Staff College in 1986 and the Defense Systems Management College in 1986. He currently serves as an Associate Member of the Naval Research Advisory Committee. Mr. Feigley retired from the Marine Corps as a Brigadier General in 2002 and received many decorations and honors during his military career.

**Joseph C. Hayden:** Joseph C. Hayden has been the Chief Operating Officer and Principal Executive Officer since April 2009. Prior to that, he was the Executive Vice President - Programs for Applied Energetics since December 2004, and was the Executive Vice President of Business Operations from November 2002 to 2004. He is a founder of the company. Mr. Hayden has almost 30 years experience in organizational leadership, business development, managing and executing large engineering projects and high technology research and development. Prior to the founding of Applied Energetics, Mr. Hayden worked at Raytheon, Inc. and also at two other start-up companies. A graduate of the U.S. Naval Academy, Mr. Hayden was a U.S. Navy Surface Warfare Officer and Nuclear Engineer before leaving the service to work in industry.

Humberto A. Astorga: Humberto A. Astorga has been our principal financial officer and principal accounting officer since September, 2009. Since March 2006, Mr. Astorga has been Controller of Applied Energetics. Prior to joining the company, Mr. Astorga was Controller of Lasertel, Inc., a semi-conductor laser manufacturer he joined in June 2002. From 2001 through June 2002, Mr. Astorga was senior financial analyst of NCS Pearson, Inc., a provider of educational assessments, products, services and solutions. Prior to joining NCS Pearson, Mr. Astorga was the SAP Business Analyst for Leoni Wiring Systems, Inc., a global supplier of wires, cables and wiring systems. From 1997 until he joined Leoni Wiring in 2000, Mr. Astorga was a senior financial analyst for the Chamberlain Group, Inc., a consumer electronics manufacturing company.

David C. Hurley: David C. Hurley has been a member of our Board of Directors since March, 2004 and served as the independent Chairman of our Board from March, 2006 until December, 2007. Mr. Hurley was appointed Vice Chairman of PrivatAir of Geneva, Switzerland on February 1, 2003, relinquishing the role of Chief Executive Officer, a position he held following the acquisition of Flight Services Group ("FSG") by PrivatAir in 2000. Mr. Hurley founded FSG in 1984. PrivatAir has major business aviation operations in over fifteen bases in the U.S. and aircraft service operations at Toulouse and, Paris, France; Dusseldorf, Munich and Hamburg, Germany; Amsterdam, The Netherlands, and Geneva, Switzerland. Mr. Hurley has over 40 years experience in operations, marketing and sales in the aerospace and telecommunications industries. Before founding FSG, he served as the Executive Vice President for Canadair Challenger (a Division of General Dynamics). Prior to that position, he served as Regional Manager of the Cessna Aircraft Company Commercial Jet Marketing Division. He began his career in 1968 as Director of Marketing, Government and Military Products Division, for RF Communications, a division of the Harris Intertype Corporation. Mr. Hurley serves as the Chairman Emeritus of the Board of the Smithsonian Institution's National Air and Space Museum, Washington, D.C.; and serves on the Boards of Aviation Partners Boeing, CAMP Systems, ExelTech Aerospace, Inc., Hexcel Corp., Genesee & Wyoming, Inc., The Corporate Angel Network, White Plains, N.Y., and Aerosat, Inc. He is an alumnus of Hartwick College and served three years in the Special Services Branch of the US Army, receiving an honorable discharge.

George P. Farley: George P. Farley, a certified public accountant, has been a member of our Board of Directors since March 2004. Mr. Farley is Chairman of our Audit Committee and also serves as a member of our Compensation Committee. Mr. Farley has been providing financial consulting services since 1999. Through 2007, Mr. Farley served as a Director and a member of the Audit Committee of iCad, Inc. He has also served as a Director and member of the Audit Committee of Preserver Insurance Company, Inc. and Acorn Holdings Corp and as a Director for Olympia Leather Company, Inc. From November 1997 to August 1999, Mr. Farley was a Chief Financial Officer of Talk.com, Inc., which provides telecommunication services. Mr. Farley was also a director of Talk.com, Inc. Mr. Farley joined BDO Seidman, LLP in 1962 and was a partner at BDO Seidman, LLP from 1972 to 1995, where he served as the managing partner of BDO's Philadelphia Office, National Director of Mergers and Acquisition and established BDO's valuation practice.

James K. Harlan: James K. Harlan has been a member of our Board of Directors since March 2004. Mr. Harlan is the Chairman of our Compensation Committee and serves as a member of our Audit Committee. Mr. Harlan is the Executive Vice President and Chief Financial Officer of HNG Storage, LP, a natural gas storage development and operations business that he helped found in 1992. From 1991 to 1997, Mr. Harlan served as Group Development Manager for the Pacific Resources Group which was engaged with various manufacturing and distribution businesses and joint ventures in Asia, Australia, and North America. He also served as operations research and planning analyst for the White House Office of Energy Policy and Planning from 1977 to 1978, the Department of Energy from 1978 to 1981, and U.S. Synthetic Fuels Corporation from 1981 to 1984. He has a PhD in Public Policy with an operations research dissertation from Harvard University and a BS in Chemical Engineering from Washington University in St. Louis. Mr. Harlan was a member of the Board of Directors of iCAD and was a member of the Audit and Governance Committees until July 2008.

John F. Levy: John F. Levy has served as a member of our Board of Directors since June, 2009. Since May 2005, Mr. Levy has served as the Chief Executive Officer of Board Advisory Services, a consulting firm that advises public companies in the areas of corporate governance, corporate compliance, financial reporting and financial strategies. Mr. Levy served as the Interim Chief Financial Officer from November 2005 to March 2006 of Universal Food & Beverage Company, which filed a voluntary petition under the provisions of Chapter 11 of the United States Bankruptcy Act on August 31, 2007. From November 1997 to May 2005, Mr. Levy served as Chief Financial Officer of MediaBay, Inc., a NASDAQ listed company and provider of spoken word audio content. While at MediaBay, he also served for a period as its Vice Chairman. Mr. Levy is a director and Chairman of the Audit Committee of Take-Two Interactive Software, Inc., a developer, marketer, distributor and publisher of interactive entertainment

software games, a director and non-executive Chairman of the Board of Applied Minerals, Inc. (formerly Atlas Mining Company), an exploration stage natural resource and mining company, a director, Lead Director and Chairman of the Audit Committee of Gilman Ciocia, Inc., a financial planning and tax preparation firm, and is a director of PNG Ventures, Inc., a producer and distributor of vehicle-quality liquid natural gas serving airports, public transit, refuse, seaports, regional trucking, taxis and government fleets markets. On September 10, 2009 PNG Ventures filed a voluntary petition under the provisions of Chapter 11 of the United States Bankruptcy Act. Mr. Levy has authored Focus on Corporate Ethics: Legal and Ethical Responsibilities of Board Members, a course on the ethical and legal responsibilities of board members initially presented to various state accounting societies. Mr. Levy is a certified public accountant with nine years of experience with the national public accounting firms of Ernst & Young, Laventhol & Horwath and Grant Thornton LLP. Mr. Levy has a B.S. degree in Economics from the Wharton School of the University of Pennsylvania and received his M.B.A. from St. Joseph's University in Philadelphia.

Mark J. Lister: Mark J. Lister has served as a member of our Board of Directors since June, 2009. Since November, 2006, Mr. Lister has been President of StratTechs, Inc., a consulting firm he founded which specializes in brokering technology within the Defense, Intelligence and Homeland Security Government markets. Mr. Lister currently serves on the Secretary of the Navy Advisory Panel and recently completed service as Chairman of the Naval Research Advisory Committee. From January 1992 to June 2006, Mr. Lister was employed by the Sarnoff Corporation where he most recently served as Senior Vice President of Government Operations. While at Sarnoff, from 2001 to 2006, Mr. Lister served as Managing Director of the Rosettex Technology and Ventures Group, a joint venture of Sarnoff Corporation and SRI International for which he was a founder, and from 1996 to 2001, Mr. Lister served as Executive Director of the National Information Display Laboratory. From 1987 to 1992, he served as Director, Advanced Development and Applications in the Research and Development Group of the Office of the Assistant Secretary of the U.S. Air Force for Space. Mr. Lister's government career began at the Naval Research Laboratory where he served as a researcher in the Space Applications Branch from 1977 to 1987. Mr. Lister has a B.S. in Electrical Engineering from Drexel University, a B.S. in Mathematics from St. Vincent College and a MEA from George Washington University.

#### Director Qualifications, Experience and Skills

All of our directors bring to our Board a wealth of executive leadership experience derived from their service as senior executives and, in many cases, founders of industry or knowledge specific consulting firms or operational businesses. They also offer extensive public company board experience. Each of our board members has demonstrated strong business acumen and an ability to exercise sound judgment and has a reputation for integrity, honesty and adherence to ethical standards. When considering whether directors and nominees have the experience, qualifications, attributes and skills, taken as a whole, to enable the Board of Directors to satisfy its oversight responsibilities effectively in light of the company's business and structure, the Corporate Governance and Nominating Committee and the Board of Directors focused primarily on the information discussed in each of the Directors' individual biographies set forth above and the specific individual qualifications, experience and skills as described below:

- General Feigley's service in the United States Marine Corps and ownership and operation of a defense consulting firm provides us with invaluable insight into our government customers' needs and requirements, as well as contacts to key personnel within these companies.
- Mr. Farley's extensive knowledge of accounting, the capital markets, financial reporting and financial strategies from his extensive public accounting experience, and prior services as a chief financial officer of a public company and as audit committee member of several public companies. Mr. Farley specialized in "Transactional Accounting" managing the accounting and auditing function for numerous public financings, mergers, acquisitions, reorganizations and business dispositions. In 1993, Mr. Farley was part of the team that created a new financing vehicle, the Specified Purpose Acquisition Company "SPAC".
- David Hurley's extensive knowledge of our markets and customers and the capital markets through his service on the boards of directors of several public and private companies which operate in the defense and aerospace industries. Mr. Hurley also provides extensive knowledge of corporate governance matters and holds a Professional Director Certification from the Corporate Directors Group, a national education and public company director credentialing organization.
- Mr. Harlan's service in senior executive positions in manufacturing and operations provide our Board with a wealth of knowledge for these aspects of our business. Mr. Harlan has significant experience with management and commercial issues associated with technology based businesses that comprise an important aspect of our business position. Mr. Harlan also has prior experience in serving on the compensation committee of other public companies.
- Mr. Levy's extensive knowledge of accounting, the capital markets, corporate governance, corporate compliance, financial reporting and financial strategies from his public accounting firm experience and service as chief financial



officer and audit committee member of several public companies, as well as through the services he provides to public companies through Board Advisory Services, a consulting firm he founded.

- Mr. Lister's broad perspective regarding our customers, markets and bringing defense industry applications to market gained through the services provided by his consulting firm to customers in the Defense, Intelligence and Homeland Security Government markets, as well as from his current and previous positions with the Navy Advisory Panel and Navel Research Advisory Committee and senior assignment with the U.S. Air Force Office of Space Systems.

#### Section 16(A) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires certain officers and directors of Applied Energetics, and any persons who own more than ten percent of the common stock outstanding to file forms reporting their initial beneficial ownership of shares and subsequent changes in that ownership with the SEC and the NASDAQ Stock Market. Officers and directors of Applied Energetics, and greater than ten percent beneficial owners are also required to furnish us with copies of all such Section 16(a) forms they file. None of our officers or directors failed to file any Section 16(a) forms, nor were any such persons late in making any such filings.

## Code of Ethics

Applied Energetics has adopted a Code of Business Conduct and Ethics that applies to all of Applied Energetics' employees and directors, including its principal executive officer, principal financial officer and principal accounting officer. Applied Energetics' Code of Business Conduct and Ethics covers all areas of professional conduct including, but not limited to, conflicts of interest, disclosure obligations, insider trading, confidential information, as well as compliance with all laws, rules and regulations applicable to Applied Energetics' business.

Upon request made to us in writing at the following address, our Code of Ethics and Business Conduct will be provided without charge:

Applied Energetics, Inc.  
Attention: Compliance Officer  
3590 East Columbia Street  
Tucson, AZ 85714

## Committees of the Board of Directors

### Audit Committee

The Audit Committee of the Board of Directors is comprised of Messrs. Farley, Harlan and Levy. The Audit Committee makes recommendations concerning the engagement of independent public accountants, reviews the scope and results of the audit engagement with the independent public accountants, approves professional services provided by the independent public accountants, reviews the independence of the independent public accountants, considers the range of audit and non-audit fees and reviews the adequacy of our internal accounting controls. Our Board of Directors has determined that each committee member meets the independence and financial literacy requirements under current NASDAQ rules. In addition, our Board of Directors has determined that Mr. Farley is an "audit committee financial expert" as defined under Item 407 of Regulation S-K of the SEC. Refer to Item 10 above for Mr. Farley's qualifications.

### Compensation Committee

The Compensation Committee of the Board of Directors is comprised of Messrs. Harlan, Farley and Lister. The committee is responsible for establishing and maintaining executive compensation practices designed to encourage company profitability and enhance long-term shareholder value.

### Nominating and Corporate Governance Committee

The Nominating and Corporate Governance Committee is comprised of Messrs. Hurley and Feigley. The Committee is responsible for establishing and maintaining corporate governance practices designed to aid the long-term success of Applied Energetics and effectively enhance and protect shareholder value.

### Strategic Planning Committee

The Strategic Planning Committee is comprised of Messrs. Lister (Chairman), Feigley and Levy. The Committee is responsible for providing oversight to establish strategic direction for the Company, develop with Company management and recommend to the Board a short- and long-term strategic plan for the Company, periodically review and update the plan, investigate and review merger, acquisition, joint venture and other business combination and strategic opportunities and to provide oversight for monitoring and executing strategies.



## ITEM 11. EXECUTIVE COMPENSATION

## Summary Compensation Table

The following table discloses, for the periods presented, the compensation for the persons who served as our Principal Executive Officer and our Principal Financial Officer for the years ended December 31, 2009 and 2008 (the “Named Executives”).

## SUMMARY COMPENSATION TABLE

| Name and Principal Position  | Year | Salary (1) | Bonus (2) | Stock Awards (3) | Option Awards (4) | All Other Compensation (5) | Total      |
|--|------|------------|-----------|------------------|-------------------|----------------------------|------------|
| Joseph C. Hayden<br>Chief Operating Officer,<br>principal executive officer                                      | 2009 | \$ 209,615 | \$ -      | \$ -             | \$ -              | \$ 4,479                   | \$ 214,094 |
|  | 2008 | \$ 225,000 | \$ -      | \$ -             | \$ -              | \$ 4,813                   | \$ 229,813 |
| Humberto A Astorga<br>Director of Finance,<br>principal financial officer,<br>Controller                         | 2009 | \$ 120,769 | \$ 22,750 | \$ -             | \$ 61,547         | \$ 1,650                   | \$ 206,716 |
|  | 2008 | \$ 112,500 | \$ 8,000  | \$ -             | \$ -              | \$ 3,488                   | \$ 123,988 |
| Dana A. Marshall<br>Former Chairman, Chief<br>Executive Officer, President<br>and Assistant Secretary<br>(6)     | 2009 | \$ 122,753 | \$ 20,000 | \$ 174,662       | \$ 37,039         | \$ 501,484                 | \$ 855,938 |
|  | 2008 | \$ 350,000 | \$ -      | \$ -             | \$ -              | \$ 71,949                  | \$ 421,949 |
| Kenneth M. Wallace<br>Former Chief Financial<br>Officer, principal<br>accounting officer<br>and Secretary<br>(7) | 2009 | \$ 173,095 | \$ -      | \$ 90,618        | \$ 70,847         | \$ 155,587                 | \$ 490,147 |
|  | 2008 | \$ 225,000 | \$ -      | \$ -             | \$ -              | \$ 7,064                   | \$ 232,064 |

- (1) Mr. Hayden’s 2009 salary reflects the voluntary decrease of his base salary to \$200,000 effective 5/11/09. Mr. Astorga’s 2009 salary reflects the increase of his base salary to \$ 137,500 effective September 1, 2009 as a result of his acceptance of the promotion to Principal Financial officer from Controller of the company. Messrs. Marshall and Wallace’s 2009 salaries reflect only the base salary.
- (2) Mr. Astorga’s cash bonus of \$22,750 in 2009 was determined by the compensation committee.
- (3) The amounts included in the “Stock Awards” column represent the aggregate grant date fair value in 2009 and 2008 related to restricted stock awards, computed in accordance with FASB ASC Topic 718. For a discussion of valuation assumptions, see Note 7 to our 2009 Consolidated Financial Statements.
- (4) The amounts included in the “Option Awards” column represent the aggregate grant date fair value in 2009 and 2008 related to stock option awards, computed in accordance with FASB ASC Topic 718. For a discussion of valuation assumptions, see Note 7 to our 2009 Consolidated Financial Statements.
- (5) The 2009 amounts shown in the “All Other Compensation” column are attributable to Messrs. Marshall and Wallace as severance. Also included in this amount is the company match expense for 401(k). The 2008 amounts shown in the “All Other Compensation” column are attributable to Mr. Marshall receiving \$39,411 for temporary living, travel

and automobile expenses, and \$25,105 “gross up” for the payment of taxes for such expenses. Also included in this amount is the company match expense for 401(k). All named executives received the employer match benefit where we match 50% of the employees’ 401(K) contribution up to 3% of their eligible compensation to their 401(K) plans, a benefit that is available to all employees. Additionally, “All Other Compensation” includes the dollar value of life insurance premiums paid by us for all named executive officers. The amounts shown in the “All Other Compensation” column for Mr. Marshall include payments for commuting costs, temporary housing assistance and relocation assistance, Mr. Marshall also received reimbursements of automotive expenses.

- (6) Mr. Marshall served in such capacities until March 31, 2009.  
 (7) Mr. Wallace served in such capacities until September 1, 2009.

#### Employment Agreements for Named Executive Officers

We currently have no employment agreements for named executive officers. Previously, we were obligated under employment agreements with Messrs. Marshall and Wallace, but each executive separated from the company during 2009.

#### Outstanding Equity Awards at Fiscal Year-End

The following table discloses unexercised options held by the Named Executives at December 31, 2009:

#### OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

| Name                | Option Awards   |   |                       |                        | Stock Awards                                   |  |
|---------------------|---|---|-----------------------|------------------------|--|--|
|                     | Number of Securities Underlying Unexercised Options Exercisable (#) | Number of Securities Underlying Unexercised Options Unexercisable (#) | Option Exercise Price | Option Expiration Date | Number of shares of stock that have not vested | Market Value of Shares of stock that have not vested |
| Joseph C. Hayden    | -   | -   |                       |                        | 13,500(1)                                      | \$ 4,725   |
| Humberto A. Astorga | 58,000(2)   | -   | \$ 0.50               | 03/09/2012             |  |  |
|                     | 83,333(3)   | 166,667(3)  | \$ 0.40               | 07/16/2014             |  |  |
|                     | -   | -   | \$ -                  |                        | 8,667(4)                                       | \$ 3,033   |
|                     | -   | -   | \$ -                  |                        | 4,563(5)                                       | \$ 1,597   |

- (1) Restricted stock grant vested 13,500 shares on each of December 1, 2008 and 2009. An additional 13,500 shares will vest on December 1, 2010. These restricted stock awards are from the 2007 Stock Incentive Plan.  
 (2) Mr. Astorga exchanged options to purchase 116,000 shares of common stock in March, 2009 for options to purchase 58,000 of common stock exercisable at \$0.50 per share. These options are from the 2004 Stock Incentive Plan.  
 (3) Options vested on July 16, 2009. Additional options to purchase shares vest annually on the third day following the filing of form 10-Q in each of 2010 and 2011. These options are from the 2007 Stock Incentive Plan.  
 (4) Restricted stock grant vested 8,667 shares on January 10, 2008 and 8,666 shares on January 10, 2009. An additional 8,667 shares will vest on January 10, 2010. These restricted stock units are from the 2004 Stock Incentive Plan.  
 (5) Restricted stock grant vested 4,564 shares on December 1, 2008, and 4,563 shares on December 1, 2009. Additionally, 4,563 shares vest on December 1, 2010. These restricted stock awards are from the 2007 Stock Incentive Plan.  
 (6) The market value of shares or units of stock that have not vested as reported in the table above is determined by multiplying the closing market price of our common stock on the last trading day of 2009 of \$0.35 by the number of shares stock that have not vested.

#### Payments upon Termination or Change-In-Control

On March 31, 2009, we entered into a separation agreement with Dana Marshall, pursuant to which his employment was terminated. Pursuant to the agreement, we made total cash payments of approximately \$485,000 to Mr.

Marshall. These payments consisted of a \$135,000 lump sum payment and twelve monthly payments of \$29,167. In addition, we accelerated the vesting of 137,500 unvested shares of restricted stock and unvested options to purchase 800,000 shares of common stock. As such, all of Mr. Marshall's equity awards were modified pursuant to ASC 718 "Compensation – Stock Compensation", and all appropriate charges have been expensed. The options expired in July 2009, pursuant to their terms.

On September 1, 2009, we entered into a separation agreement with Kenneth Wallace, pursuant to which his employment was terminated. Pursuant to the agreement, we made total cash payments of approximately \$149,000 to Mr. Wallace. These payments consisted of a \$29,000 lump sum payment, four monthly payments of \$28,125 and a lump sum payment of \$7,682 as reimbursement for health insurance premiums.

## Director Compensation

The following table discloses our director compensation for the year ended December 31, 2009:

| Name             | Fees Earned<br>or   |                  | Total      |
|------------------|---------------------|------------------|------------|
|                  | Paid in Cash<br>(1) | Option<br>Awards |            |
| David C. Hurley  | \$ 53,750(2)        | \$ 19,593        | \$ 73,343  |
| George P. Farley | \$ 75,000(3)        | \$ 23,171        | \$ 98,171  |
| James K. Harlan  | \$ 56,875(4)        | \$ 23,191        | \$ 80,066  |
| James M. Feigley | \$ 68,750(5)        | \$ 90,655        | \$ 159,405 |
| John F. Levy     | \$ 29,167(6)        | \$ 12,352        | \$ 41,519  |
| Mark J. Lister   | \$ 29,167(7)        | \$ 12,352        | \$ 41,519  |

- (1) The amounts included in the “Option Awards” column represent aggregate grant date fair value in 2009 related to share awards to directors, computed in accordance with FASB ASC Topic 718. For a discussion of valuation assumptions, see Note 7 to our 2009 Consolidated Financial Statements. All options granted to directors in 2009 vested immediately and became immediately exercisable upon grant.
- (2) Mr. Hurley was granted options to purchase 55,000 shares of common stock in April, 2009 with a grant date fair value, computed in accordance with FASB ASC Topic 718, \$11,708 of which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718. In addition, as part of our March, 2009 option exchange which was available to all employee and director holding options under our stock incentive plans (the “option exchange”), Mr. Hurley exchanged options to purchase 285,000 shares of common stock in March, 2009 for options to purchase 142,500 of common stock exercisable at \$0.50 per share. The grant date fair value for the exchange, which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718, was \$7,885.
- (3) Mr. Farley was granted options to purchase 75,000 shares of common stock in April, 2009 with a grant date fair value, computed in accordance with FASB ASC Topic 718, of \$15,965 which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718.
- (4) Mr. Harlan was granted options to purchase 80,000 shares of common stock in April, 2009 with a grant date fair value, computed in accordance with FASB ASC Topic 718, of \$17,029 which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718. In addition, Mr. Harlan participated in the option exchange and exchanged options to purchase 222,500 shares of common stock in March, 2009 for options to purchase 111,250 of common stock exercisable at \$0.50 per share. The grant date fair value for the exchange, which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718, was \$6,162.
- (5) Mr. Feigley was granted options to purchase 425,000 shares of common stock in April, 2009 with a grant date fair value, computed in accordance with FASB ASC Topic 718, of \$90,467 which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718. In addition, Mr. Feigley participated in the option exchange and exchanged options to purchase 10,000 shares of common stock in March, 2009 for options to purchase 5,000 of common stock exercisable at \$0.50 per share. The grant date fair value for the exchange, which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718, was \$188.
- (6) Mr. Levy was granted options to purchase 50,000 shares of common stock in June, 2009 with a grant date fair value, computed in accordance with FASB ASC Topic 718, of \$12,352 which was recognized in 2009 for financial statement reporting purposes in accordance with FASB ASC Topic 718.
- (7) Mr. Lister was granted options to purchase 50,000 shares of common stock in June, 2009 with a grant date fair value, computed in accordance with FASB ASC Topic 718, of \$12,352 which was recognized in 2009 for financial



statement reporting purposes in accordance with FASB ASC Topic 718. In addition, Mr. Lister was awarded an additional payment of \$25,000 as director fees in January, 2010 for his services in light of the time and effort spent in leading the corporation's strategic planning initiatives.

In January of 2009, the board amended the Independent Directors Compensation Program to delay the timing of automatic stock grants and option awards from January 15th of each year until the third business day following the company's release of its audited financial statements for the prior year.

Additionally, under the program as amended, on the third day following the filing of its form 10-K each year (or on the first business day thereafter if such date is not a business day), each independent director received options to purchase 10,000 shares of the Registrant's common stock. The exercise price of such options shall be the closing sale price of our common stock on the date of grant.

Under the program, if at anytime an independent director serves in more than one position of Chairman of the Board, lead independent director and Chairman of the Audit Committee or Compensation Committee, that director shall receive the higher level compensation paid for any such position the director then holds.

In April of 2009, the board agreed to reduce its compensation under its Independent Directors Compensation Program. The Chairman of the Board and Chair of the Audit Committee each received \$75,000 annually, and were granted options to purchase 75,000 shares of the Corporation's common stock. The Chair of the Compensation Committee and the Chair of the Nominating and Governance Committee each received \$55,000 annually, and were granted options to purchase 55,000 shares of the Corporation's common stock. The remaining independent directors received \$50,000 annually, and, upon their appointment in June, were granted 50,000 shares of the Corporation's common stock.

In January 2010, the Board of Directors terminated the Independent Directors Compensation Program. In addition, in January of 2010, the Board set the annual cash compensation for independent directors as follows: the Chairman of the Board, and/or Lead Independent Director, if independent, shall receive \$125,000 per year; the Chairman of the Audit Committee shall receive \$75,000 per year; the Chairman of the Compensation Committee shall receive \$55,000 per year, the Chairman of the Nominating Committee shall receive \$55,000 per year and each other independent director shall receive \$50,000 per year. In addition, the Chairman of the Strategic Planning Committee was awarded an additional payment of \$50,000 annually for his services in leading the corporation's strategic planning initiatives.

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

The following table sets forth information regarding the beneficial ownership of our Common Stock, based on information provided by the persons named below in publicly available filings, as of March 12, 2010:

- each of our directors and executive officers;
- all directors and executive officers of ours as a group; and
- each person who is known by us to beneficially own more than five percent of the outstanding shares of our Common Stock.

Unless otherwise indicated, the address of each beneficial owner is care of Applied Energetics, 3590 East Columbia Street, Tucson, Arizona 85714. Unless otherwise indicated, the company believes that all persons named in the following table have sole voting and investment power with respect to all shares of common stock that they beneficially own.

For purposes of this table, a person is deemed to be the beneficial owner of the securities if that person has the right to acquire such securities within 60 days of March 12, 2010 upon the exercise of options or warrants. In determining the percentage ownership of the persons in the table below, we assumed in each case that the person exercised all options and warrants which are currently held by that person and which are exercisable within such 60 day period, but that options and warrants held by all other persons were not exercised, and based the percentage ownership on 89,065,252 shares outstanding on March 12, 2010.

| Name of Beneficial Owner                                    | Number of Shares<br>Beneficially<br>Owned (1) | Number of<br>Options<br>Owned (2) | Percentage of<br>Shares<br>Beneficially<br>Owned (1) |
|---|---|-----------------------------------|--|
| Superius Securities Group Inc. Profit Sharing Plan          | 8,535,997                                     | 2                                 | 9.6%   |
| State of Wisconsin Investment Board                         | 8,388,570                                     | 3                                 | 9.4%   |
| Artis Capital Management, L.P.                              | 6,657,129                                     | 4                                 | 7.5%   |
| Joseph C. Hayden  | 5,994,468                                     |                                   | 6.7%   |
| Stephen W. McCahon  | 5,528,868                                     | 5                                 | 6.2%   |
| James M. Feigley  | 439,947                                       | 6                                 | *  |
| David C. Hurley   | 231,284                                       | 7                                 | *  |
| James K. Harlan   | 214,365                                       | 8                                 | *  |
| Humberto A. Astorga   | 175,849                                       | 9                                 | *  |
| John F. Levy  | 50,000  | 10                                | *  |
| Mark J. Lister  | 50,000  | 11                                | *  |
| George P. Farley  | 0   | 12                                | *  |
| All directors and executive officers as a group (8 persons) | 7,155,913                                     |                                   | 7.9%   |

\* Less than 1%

(1) Computed based upon the total number of shares of common stock, restricted shares of common stock and shares of common stock underlying options held by that person that are exercisable within 60 days of March 12, 2010.

(2) Based on information contained in a report on Schedule 13G filed with the SEC on October 29, 2009. The address of Superius Securities Group Inc. Profit Sharing Plan is 94 Grand Ave., Englewood, NJ 07631.

- (3)Based on information contained in a report on Schedule 13G filed with the SEC on February 16, 2010. The address of the State of Wisconsin Investment Board is P. O. Box 7842, Madison, WI 53707.
- (4)Based on information contained in a report on Schedule 13G filed with the SEC on February 16, 2010: The address of Artis Capital Management, LLC (“Artis”) is One Market Plaza, Spear Street Tower, Suite 1700, San Francisco, CA 94105. Artis is a registered investment adviser and is the investment adviser of investment funds that hold the company’s stock for the benefit of the investors in those funds. Artis Inc. is the general partner of Artis. Stuart L. Peterson is the president of Artis Inc. and the controlling owner of Artis and Artis Inc. Each of Artis, Artis Inc., and Mr. Peterson disclaims beneficial ownership of the Stock, except to the extent of its or his pecuniary interest therein.
- (5) Based on information provided by Dr. McCahon on March 12, 2010.
- (6) Represents 9,947 shares of common stock and 430,000 options exercisable within 60 days of March 12, 2010.
- (7) Represents 33,748 shares of common stock and 197,500 options exercisable within 60 days of March 12, 2010.

- (8) Represents 23,115 shares of common stock and 191,250 options exercisable within 60 days of March 12, 2010.
- (9) Represents 34,516 shares of common stock and 141,333 options exercisable within 60 days of March 12, 2010.
- (10) Represents 50,000 options exercisable within 60 days of March 12, 2010.
- (11) Represents 50,000 options exercisable within 60 days of March 12, 2010.
- (12) Mr. Farley denies beneficial ownership of the common shares and common shares issuable upon exercise of options he transferred to various LLCs.

#### Securities Authorized for Issuance Under Equity Compensation Plans

The following table details information regarding our existing equity compensation plans as of December 31, 2009:

| Plan category  | Equity Compensation Plan Information                                   |  |   |
|--|--|--|---|
|  | Number of securities to be issued upon exercise of outstanding options | Weighted-average exercise price of outstanding options | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
| Equity compensation plans approved by security holders     | 4,493,632  | \$ 0.46  | 8,807,153   |
| Equity compensation plans not approved by security holders | 14,250   | \$ 5.00  | -   |
| <b>Total</b>   | <b>4,507,882</b>   | <b>\$ 0.47</b>   | <b>8,807,153</b>  |

In April, 2009, under the Independent Directors Compensation Program, the members of the Board of Directors received options to purchase 635,000 shares of common stock. In June, 2009, the new members of the board received options to purchase 100,000 shares of common stock.

The following is a description of currently open stock option and equity plans.

The 2004 Stock Incentive Plan ("2004 Plan"), which provides for the grant of any or all of the following types of awards: (1) stock options, which may be either incentive stock options or non-qualified stock options, (2) restricted stock, (3) deferred stock and (4) other stock-based awards. A total of 3,000,000 shares of common stock were originally reserved for distribution pursuant to the 2004 Plan. On June 28, 2005, the stockholders approved an amendment to the 2004 Plan to (i) increase the number of shares of the company's common stock, \$.001 par value, authorized for issuance under the 2004 Plan by 2,000,000 shares from 3,000,000 shares to 5,000,000 shares, and (ii) set the maximum number of shares of common stock which may be issued upon the exercise of incentive stock options at 3,000,000 shares. As of December 31, 2009, options to purchase 4,063,944 shares were outstanding under this plan. Additionally, as of December 31, 2009, there were 112,507 unvested restricted stock units outstanding under this plan.

The 2007 Stock Incentive Plan ("2007 Plan"), which provides for the grant of any or all of the following types of awards: (1) stock options, which may be either incentive stock options or non-qualified stock options, (2) restricted stock, (3) deferred stock, (4) stock appreciation rights, and (5) other stock-based awards. A total of 10,000,000 shares of common stock have been reserved for distribution pursuant to the 2007 Plan provided, however, that the maximum number of shares available for award or grant during the first five years of the 2007 Plan shall be an aggregate of 5,000,000 shares; and provided further that the maximum number of shares available for award or grant during any

consecutive twelve month period shall be 1,000,000 shares during the first two years of the 2007 Plan and 2,000,000 shares during the third through fifth years of the 2007 Plan. As of December 31, 2009, options to purchase 429,688 shares were outstanding under this plan. As of December 31, 2009, 111,635 restricted stock grants have been awarded from this plan.

We have, from time to time, also granted non-plan options and other equity-based awards to certain officers, directors, employees and consultants. No inducement grants as defined were made during 2009.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Transactions with Related Parties

On March 31, 2009, we entered into a consulting agreement with Dr. Stephen McCahon, a principal stockholder, providing for his full-time consulting services for an initial term of one year for a fee of \$18,750 per month. The term of the agreement automatically extends on a monthly basis unless terminated upon thirty days notice. During 2009, he was paid approximately \$167,000, and was owed approximately \$18,850 in fees and expenses at December 31, 2009.

Review, Approval or Ratification of Transactions with Related Persons

Pursuant to our Code of Business Conduct, all officers and directors of the company who have, or whose immediate family members have, any direct or indirect financial or other participation in any business that supplies goods or services to Applied Energetics, are required to notify our Compliance Officer, who will review the proposed transaction and notify the Audit Committee of our Board of Directors for review and action as it sees fit, including, if necessary, approval by our Board of Directors.

Director Independence

The Board has determined that Messrs. Hurley, Farley, Harlan, Feigley, Levy and Lister meet the director independence requirements applicable to NASDAQ listed companies.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES:

The following is a summary of the fees billed to the company by BDO Seidman, LLP for professional services rendered for the years ended December 31, 2009 and 2008.

|            | 2009       | 2008       |
|------------|------------|------------|
| Audit Fees | \$ 239,000 | \$ 385,000 |
| Tax Fees   | \$ 12,000  | \$ 11,000  |

Fees for audit services include fees associated with the annual audit of the company and its subsidiaries, the review of our quarterly reports on Form 10-Q and in 2008, the internal control evaluation under Section 404 of the Sarbanes-Oxley Act of 2002. Tax fees include tax compliance, tax advice and tax planning related to federal and state tax matters.

Pre-Approval Policies and Procedures

Consistent with the SEC requirements regarding auditor independence, our Audit Committee has adopted a policy to pre-approve all audit and permissible non-audit services provided by our independent registered public accounting firm. Under the policy, the Audit Committee must approve non-audit services prior to the commencement of the specified service. Our independent registered public accounting firm, BDO Seidman, LLP, have verified, and will verify annually, to our Audit Committee that they have not performed, and will not perform any prohibited non-audit service.





PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

The following documents are filed or incorporated by reference as part of this report:

- (a)(1) The Consolidated Financial Statements of Applied Energetics, Inc. are filed as part of this report on page F-1 following the signatures.

Exhibits:

EXHIBIT  
NUMBER

DESCRIPTION

- | EXHIBIT<br>NUMBER | DESCRIPTION   |
|-------------------|---|
| 2.1               | Amended and Restated Plan and Agreement of Merger entered into as of March 17, 2004, by and among U.S. Home & Garden, Inc. (“USHG”), Ionatron Acquisition Corp., a wholly-owned subsidiary of USHG, Robert Kassel (for purposes of Sections 5.9, 6.2(d), 6.2(j), 9.4 and 10.10 only), Fred Heiden (for purposes of Section 9.4 only), and Ionatron, Inc. and Robert Howard, Stephen W. McCahon, Thomas C. Dearmin and Joseph C. Hayden (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on March 24, 2004). |
| 3.1               | Certificate of Incorporation, as amended, (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-KSB for the fiscal year ended June 30, 1995).  |
| 3.2               | Certificate of Amendment of Certificate of Incorporation of the Registrant filed with the Secretary of State of the State of Delaware on April 29, 2004 (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-Q for the quarterly period ended March 31, 2004).  |
| 3.3               | Certificate of Elimination of the 10% Series A Convertible Preferred Stock of the Registrant (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on October 28, 2005).   |
| 3.4               | Certificate of Designation of the 6.5% Series A Redeemable Convertible Preferred Stock of the Registrant (incorporated by reference to the comparable exhibit filed with the Registrant’s 8-K filed with the SEC on October 28, 2005).  |
| 3.5               | Certificate of Ownership and Merger of Applied Energetics, Inc. into Ionatron, Inc. (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on February 20, 2008).   |
| 3.6               | Amended and Restated By-laws of the Registrant (incorporated by reference to Exhibit 3 of the Registrant’s Form 10-Q for the Quarter ended June 30, 2007).  |
| 3.7               | Certificate of Amendment to Certificate of Incorporation filed with the Secretary of State of the State of Delaware on September 10, 2007.  |
| 4.1               | Form of certificate evidencing Common Stock, \$.001 par value, of the Registrant  |
| 4.2               | Rights Agreement dated as of October 1, 1998 between the Registrant and Continental Stock Transfer & Trust Company (incorporated by reference to Exhibit 4.1 filed with the Registrant’s Current Report on Form 8-K for the event dated October 1, 1998).   |
| 4.3               | Form of Registration Rights Agreement by and among the Registrant and each of the Purchasers named on the schedule thereto (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on October 28, 2005).   |
| 10.1              | 1991 Stock Option Plan (incorporated by reference to Exhibit 10.5 of the Registrant’s Registration Statement on Form S-1 (Registration No. 33-45428).   |
| 10.2              | 1995 Stock Option Plan, as amended (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-K for the fiscal year ended June 30, 1999).   |
| 10.3              | 1997 Stock Option Plan, as amended (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-K for the fiscal year ended June 30, 1999).   |
| 10.4              | 1999 Stock Option Plan (incorporated by reference to Exhibit A filed with the Registrant’s Proxy Statement dated May 14, 1999 filed on Schedule 14A).   |
| 10.5              | 2004 Stock Incentive Plan (incorporated by reference to Appendix B to the Registrant’s Proxy Statement on Schedule 14A filed with the SEC on May 25, 2005).   |
| 10.6              | Form of 2004 Stock Incentive Plan Non-Qualifying Stock Option Agreement for Directors (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-Q for the quarterly period ended June 30, 2005).   |

- 10.7 Employment Agreement dated August 18, 2006 between the Registrant and Dana A. Marshall (incorporated by reference to the comparable exhibit filed with the Registrant's Form 10-K for the year ended December 31, 2006).
- 10.8 2007 Stock Incentive Plan (as amended).
- 10.9 Employment Agreement dated October 26, 2007 between the Registrant and Kenneth M. Wallace (incorporated by reference to the comparable exhibit filed with the Registrant's Form 8-K filed with the SEC on October 26, 2007).

- 10.10 Amendment No.1 to Employment Agreement dated August 18, 2006 between the Registrant and Dana A. Marshall (incorporated by reference to the comparable exhibit filed with the Registrant's Form 8-K filed with the SEC on October 26, 2007).
- 10.11 Amendment No. 2 to Employment Agreement dated August 18, 2006 between the Registrant and Dana A. Marshall.
- 10.12 Agreement and Complete and Full General Release by and between Dana A. Marshall and the Registrant dated March 31, 2009 (incorporated by reference to the comparable exhibit filed with the Registrant's Form 10-Q filed with the SEC on May, 11, 2009).
- 10.13 Consulting Agreement between Dr. Stephen W. McCahon and the Registrant dated as of March 31, 2009 (incorporated by reference to the comparable exhibit filed with the Registrant's Form 10-Q filed with the SEC on May, 11, 2009).
- 10.14 Agreement and Complete and Full General Release by and between Kenneth M. Wallace and the Registrant dated September 1, 2009 (incorporated by reference to the comparable exhibit filed with the Registrant's Form 10-Q filed with the SEC on November, 9, 2009).
- 21 Subsidiaries (incorporated by reference to the comparable exhibit filed with the Registrant's Form 10-K for the year ended December 31, 2006)
- 23 Consent of BDO Seidman, LLP
- 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Principal Executive Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Principal Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Compensation Committee Charter (incorporated by reference to the comparable exhibit filed with the Registrant's Form 10-K for the year ended December 31, 2006)
- 99.2 Corporate Governance and Nominating Committee Charter
- 99.3 Audit Committee Charter

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on the 15th day of March, 2010.

APPLIED ENERGETICS, INC.

By /s/ Joseph C. Hayden  
Joseph C. Hayden  
Chief Operating Officer,  
Principal  
Executive Officer and Secretary

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on the 15th day of March, 2010 by the following persons on behalf of the registrant and in the capacities indicated.

| Name   | Title   |
|--|---|
| /s/ James M. Feigley<br>James M. Feigley       | Chairman of the Board   |
| /s/ David C. Hurley<br>David C. Hurley         | Director  |
| /s/ George P. Farley<br>George P. Farley       | Director  |
| /s/ James K. Harlan<br>James K. Harlan         | Director  |
| /s/ John F. Levy<br>John F. Levy               | Director  |
| /s/ Mark J. Lister<br>Mark J. Lister           | Director  |
| /s/ Joseph C. Hayden<br>Joseph C. Hayden       | Chief Operating Officer,<br>(principal executive officer)                       |
| /s/ Humberto A. Astorga<br>Humberto A. Astorga | Controller<br>(principal financial officer and principal accounting<br>officer) |

APPLIED ENERGETICS, INC.

FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 and 2008  
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CONSOLIDATED FINANCIAL STATEMENTS:

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Applied Energetics, Inc.

Tucson, Arizona

We have audited the accompanying consolidated balance sheets of Applied Energetics, Inc. as of December 31, 2009 and 2008 and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

/s/ BDO Seidman, LLP

Phoenix, Arizona

March 15, 2010

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APPLIED ENERGETICS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEAR ENDED  
DECEMBER 31 ,  
2009                      2008

|   |                |                 |
|---|----------------|-----------------|
| Revenue   | \$ 7,459,808   | \$ 16,614,211   |
| Cost of revenue   | 7,007,923      | 15,874,818      |
| Gross profit  | 451,885        | 739,393         |
| Operating expenses:   |                |                 |
| General and administrative  | 6,795,972      | 8,470,656       |
| Settlement expenses   | 1,337,409      | -               |
| Selling and marketing   | 631,578        | 251,349         |
| Research and development  | 1,182,652      | 1,372,396       |
| Total operating expenses  | 9,947,611      | 10,094,401      |
| Operating loss  | (9,495,726)    | (9,355,008)     |
| Other income (expense)  |                |                 |
| Interest expense  | (1,131)        | (2,099)         |
| Interest income   | 60,562         | 637,475         |
| Other income  | -              | 10              |
| Total other income  | 59,431         | 635,386         |
| Loss before provision for income taxes  | (9,436,295)    | (8,719,622)     |
| Provision (benefit) for income taxes  | -              | -               |
| Net Loss  | (9,436,295)    | (8,719,622)     |
| Preferred stock dividends   | (242,174)      | (870,985)       |
| Deemed dividend from induced conversion of Series A Preferred Stock               | -              | (3,336,734)     |
| Net loss attributable to common stockholders                                      | \$ (9,678,469) | \$ (12,927,341) |
| Net loss attributable to common stockholders per common share – basic and diluted | \$ (0.11)      | \$ (0.16)       |
| Weighted average number of common shares outstanding, basic and diluted           | 86,794,287     | 81,528,544      |

See accompanying notes to consolidated financial statements.



APPLIED ENERGETICS, INC.  
CONSOLIDATED BALANCE SHEETS

|  | DECEMBER 31 ,        |                      |
|--|----------------------|----------------------|
|  | 2009                 | 2008                 |
| <b>ASSETS</b>  |                      |                      |
| Current assets   |                      |                      |
| Cash and cash equivalents  | \$ 9,604,643         | \$ 15,242,386        |
| Certificate of Deposit   | 225,000              | 225,000              |
| Accounts receivable – net  | 1,074,944            | 2,727,853            |
| Inventory  | 785,479              | 157,189              |
| Prepaid expenses   | 447,295              | 495,718              |
| Other receivables  | 52,295               | 17,183               |
| Total current assets   | 12,189,656           | 18,865,329           |
| Long term receivable   | 205,313              | 253,130              |
| Property and equipment – net   | 2,845,607            | 3,523,641            |
| Intangible assets – net  | -                    | 36,900               |
| Other assets   | 20,800               | 29,089               |
| <b>TOTAL ASSETS</b>  | <b>\$ 15,261,376</b> | <b>\$ 22,708,089</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                      |                      |
| Current liabilities  |                      |                      |
| Accounts payable   | \$ 428,413           | \$ 883,228           |
| Estimated loss on uncompleted contract   | -                    | 98,239               |
| Accrued expenses   | 313,448              | 290,591              |
| Insurance premium financing (4.49% interest)   | 214,834              | -                    |
| Accrued compensation   | 505,188              | 1,084,880            |
| Customer deposits  | 104,160              | 11,565               |
| Billings in excess of costs  | 42,716               | -                    |
| Current portion of capital lease obligations   | -                    | 2,028                |
| Total current liabilities  | 1,608,759            | 2,370,531            |
| Deferred rent  | -                    | 4,049                |
| Total liabilities  | 1,608,759            | 2,374,580            |
| Stockholders' equity   |                      |                      |
| Series A convertible preferred stock, \$.001 par value, 2,000,000 shares authorized and 135,572 shares issued and outstanding at December 31, 2009 and 2008 (Liquidation preference \$3,389,300) | 136                  | 136                  |
| Common stock, \$.001 par value, 125,000,000 shares authorized; 88,968,812 shares issued and outstanding at December 31, 2009; 86,370,026 shares issued and outstanding at December 31, 2008      | 88,969               | 86,370               |
| Additional paid-in capital   | 76,931,065           | 73,936,085           |
| Accumulated deficit  | (63,367,553)         | (53,689,082)         |
| Total stockholders' equity   | 13,652,617           | 20,333,509           |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$ 15,261,376</b> | <b>\$ 22,708,089</b> |

See accompanying notes to consolidated financial statements.



APPLIED ENERGETICS, INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

|   | Preferred Stock |        | Common Stock |           | Additional         | Accumulated     | Total                   |
|---|-----------------|--------|--------------|-----------|--------------------|-----------------|-------------------------|
|   | Shares          | Amount | Shares       | Amount    | Paid-in<br>Capital | Deficit         | Stockholders'<br>Equity |
| Balance as of<br>December 31,<br>2007                           | 690,000         | \$ 690 | 80,244,617   | \$ 80,245 | \$ 66,344,066      | \$ (40,761,741) | \$ 25,663,260           |
| Stock issued under<br>equity incentive<br>plans                 | -               | -      | 364,570      | 364       | (364)              | -               | -                       |
| Stock-based<br>compensation<br>expense                          | -               | -      | -            | -         | 3,701,413          | -               | 3,701,413               |
| Preferred stock<br>converted into<br>common stock               | (554,428)       | (554)  | 5,232,935    | 5,233     | 3,332,055          | (3,336,734)     | -                       |
| Preferred stock<br>dividends                                    | -               | -      | 527,904      | 528       | 558,915            | (870,985)       | (311,542)               |
| Net loss for the<br>year ended<br>December 31,<br>2008          | -               | -      | -            | -         | -                  | (8,719,622)     | (8,719,622)             |
| Balance as of<br>December 31,<br>2008                           | 135,572         | 136    | 86,370,026   | 86,370    | 73,936,085         | (53,689,082)    | 20,333,509              |
| Exercise of stock<br>options                                    | -               | -      | 13,889       | 14        | (14)               | -               | -                       |
| Stock issued under<br>equity incentive<br>plans                 | -               | -      | 6,546        | 7         | (7)                | -               | -                       |
| Stock-based<br>compensation<br>expense                          | -               | -      | -            | -         | 1,765,424          | -               | 1,765,424               |
| Preferred stock<br>dividends                                    | -               | -      | 294,464      | 294       | 112,757            | (242,176)       | (129,125)               |
| Shares issued in<br>connection with<br>litigation<br>settlement | -               | -      | 2,283,887    | 2,284     | 1,116,820          | -               | 1,119,104               |
| Net loss for the<br>year ended<br>December 31,<br>2009          | -               | -      | -            | -         | -                  | (9,436,295)     | (9,436,295)             |
| Balance as of<br>December 31,                                   | 135,572         | \$ 136 | 88,968,812   | \$ 88,969 | \$ 76,931,065      | \$ (63,367,553) | \$ 13,652,617           |

2009

See accompanying notes to consolidated financial statements.

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APPLIED ENERGETICS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | FOR THE YEARS ENDED<br>DECEMBER 31, |                |
|--|-------------------------------------|----------------|
|  | 2009                                | 2008           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                |                                     |                |
| Net loss   | \$ (9,436,295)                      | \$ (8,719,622) |
| Adjustments to reconcile net loss to net cash used in operating activities |                                     |                |
| Litigation costs paid in common stock                                      | 1,119,104                           | -              |
| Depreciation and amortization  | 586,884                             | 822,197        |
| Loss on equipment disposal   | 172,850                             | 5,274          |
| Provision for losses on projects   | (98,239)                            | 193,192        |
| Noncash stock based compensation expense                                   | 1,765,424                           | 3,701,413      |
| Changes in assets and liabilities:   |                                     |                |
| Accounts receivable  | 1,652,909                           | 537,115        |
| Other receivable   | (35,112)                            | 42,800         |
| Inventory  | (628,290)                           | 1,216,249      |
| Prepaid expenses and other assets  | 56,712                              | (49,886)       |
| Long term receivables  | 47,817                              | (253,130)      |
| Deposits   | -                                   | 30,428         |
| Accounts payable   | (454,815)                           | (265,038)      |
| Billings in excess of costs  | 42,716                              | -              |
| Accrued expenses, deposits and deferred rent                               | (253,455)                           | (1,284,399)    |
| Net cash used in operating activities                                      | (5,461,790)                         | (4,023,407)    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                |                                     |                |
| Purchase of property and equipment   | (46,633)                            | (2,701,025)    |
| Proceeds from sale of available-for-sale marketable securities             | -                                   | 7,500,000      |
| Purchases of short term investment   | -                                   | (225,000)      |
| Proceeds from disposal of equipment  | 1,833                               | -              |
| Net cash provided by (used in) investing activities                        | (44,800)                            | 4,573,975      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                |                                     |                |
| Principal payments on capital lease obligation                             | (2,028)                             | (13,937)       |
| Preferred stock dividends paid   | (129,125)                           | (275,437)      |
| Net cash used in financing activities                                      | (131,153)                           | (289,374)      |
| Net increase (decrease) in cash and cash equivalents                       | (5,637,743)                         | 261,194        |
| Cash and cash equivalents, beginning of period                             | 15,242,386                          | 14,981,192     |
| Cash and cash equivalents, end of period                                   | \$ 9,604,643                        | \$ 15,242,386  |

See accompanying notes to consolidated financial statements.

APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - ORGANIZATION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of Applied Energetics, Inc. and its wholly owned subsidiaries, Ionatron Technologies, Inc. and North Star Power Engineering, Inc. ("North Star") (collectively, "company," "Applied Energetics," "we," "our" or "us"). All intercompany balances and transactions have been eliminated. Certain reclassifications have been made to prior period financial statement amounts to conform to the current presentation.

Nature of Business

Applied Energetics is involved in the development and manufacture of applied energy systems for military and commercial applications. Through our efforts in developing our core technology, Laser Guided Energy (LGE), we have gained expertise and proprietary knowledge in high performance lasers, high-voltage electronics, advanced dynamic optics and atmospheric and plasma energy interactions. We apply these technologies to deliver innovative solutions to urgent military requirements, including neutralizing improvised explosive devices ("IEDs") and other high priority missions of U.S. and allied military forces. Additionally, we develop and manufacture high-voltage and laser products for government and commercial customers for a range of applications. Applied Energetics was founded on the premise that an entrepreneurial approach to technology development would accelerate the advancement of Laser Guided Energy (LGE) to solve critical needs in the Directed Energy Weapon arena. We have developed counter-IED technology as a result of the work done on LGE.

Use of Estimates

The preparation of consolidated financial statements in conformity with United States generally accepted accounting principles requires management to make estimates, judgments and assumptions that affect the amounts reported in the financial statements and accompanying notes. Management bases its assumptions on historical experiences and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. In addition, Management considers the basis and methodology used in developing and selecting these estimates, the trends in and amounts of these estimates, specific matters affecting the amount of and changes in these estimates, and any other relevant matters related to these estimates, including significant issues concerning accounting principles and financial statement presentation. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein. Significant estimates include revenue recognition under the percentage of completion method of contract accounting, the valuation of inventory, carrying amounts of long-lived assets, valuation assumptions for share-based payments and measurements of income tax assets and liabilities.

Revenue Recognition

A majority of revenue under long-term government contracts is recorded under the percentage of completion method. Revenue, billable monthly under cost plus fixed fee contracts, is recorded as costs are incurred and includes estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. Costs include direct labor, direct materials, subcontractor costs and manufacturing and administrative overhead allowable under the contract. General and administrative expenses allowable under the terms of contracts are allocated per contract, depending on its direct

labor and material proportion to total direct labor and material of all contracts. As contracts can extend over one or more accounting periods, revisions in earnings estimated during the course of work are reflected during the accounting period in which the facts become known. When the current contract estimate indicates a loss, a provision is made for the total anticipated loss in the current period. We do not generally provide an allowance for returns from our government customers because our customer agreements do not provide for a right of return.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Following is a summary of our Reserves for Loss on Projects:

|  | Reserve For Loss on Projects |              |
|--|------------------------------|--------------|
|  | 2009                         | 2008         |
| Balance at beginning of year           | \$ 98,239                    | \$ 1,366,210 |
| Addition to loss on projects provision | 22,000                       | 193,192      |
| Write offs                             | (98,239)                     | (1,461,163)  |
| Balance at end of year                 | \$ 22,000                    | \$ 98,239    |

The asset caption “accounts receivable” includes costs and estimated earnings in excess of billings on uncompleted contracts, which represents revenue recognized in excess of amounts billed. Such revenue is billable under the terms of contracts at the end of the year, but was not invoiced until the following year and is generally expected to be collected within one year.

Revenue for other products and services is recognized when such products and services are delivered or performed and, in connection with certain sales to Government agencies, when the products and services are accepted, which is normally negotiated as part of the initial contract. Revenue from commercial, non-Governmental, customers is based on fixed price contracts where the sale is recognized upon acceptance of the product or performance of the service and when payment is probable. Contract costs are deferred in the same manner as inventory costs and are charged to operations as the related revenue from contracts is recognized. When a current contract estimate indicates a loss, a provision is made for the total anticipated loss in the period in which such facts become evident.

#### Settlement Expenses

Litigation settlement expenses for 2009 were approximately \$1.3 million. This includes the fair value of the 2,283,887 shares issued in settlement of the class action lawsuit filed by George Wood and Raymond Deedon, and the derivative action filed by John T. Johnasen on September 29, 2009, and the legal fees not covered by insurance proceeds.

#### Net Loss Attributable to Common Stockholders

Basic loss per common share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding for the period before giving effect to stock options, stock warrants, restricted stock units and convertible securities outstanding, which are considered to be dilutive common stock equivalents. Diluted net loss per common share is calculated based on the weighted average number of common and potentially dilutive shares outstanding during the period after giving effect to dilutive common stock equivalents. Contingently issuable shares are included in the computation of basic loss per share when issuance of the shares is no longer contingent. The number of options, warrants, restricted stock units and our Series A Convertible Preferred Stock, which were not included in the computation of earnings per share because the effect was antidilutive, was 5,927,772 and 6,882,647 for the years ended December 31, 2009 and 2008, respectively.

#### Fair Value of Current Assets and Liabilities

The carrying amount of the certificate of deposit, accounts receivable, accounts payable and accrued expenses approximate fair value due to the short maturity of these instruments



Cash and Cash Equivalents

Cash equivalents are investments in money market funds or securities with an initial maturity of three months or less. These money market funds are invested in government and US treasury based securities.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

#### Certificate of Deposit

We have a single certificate of deposit with an initial maturity of one year. The certificate is covered by Federal Deposit Insurance Corporation limits, and is not considered to be at risk. The investment will be held to maturity and is recorded at cost, which approximates fair value.

#### Accounts Receivable and Allowance for Doubtful Accounts

Our accounts receivable balance includes contract receivables related to completed and in-progress contracts, retainers and costs and estimated earnings in excess of billings on uncompleted contracts.

We do not generally provide an allowance for receivables from the Government. We have non-Government customers for which we provide for potentially uncollectible accounts receivable by use of the allowance method. The allowance is provided based upon a review of the individual accounts outstanding, and the company's prior history of uncollectible accounts receivable. As of December 31, 2009 and 2008, we believe all receivable balances to be fully collectible and accordingly, have no allowance for doubtful accounts at such dates.

#### Inventory

Inventories include material, direct labor and related manufacturing overhead and are stated at the lower-of-cost (determined on a weighted average basis) or market for raw materials and work-in-process inventory. When actual contract cost and the estimate to complete exceed the estimated contract revenues, a loss provision is recorded. Due to the nature of our inventory, we analyze inventory on an item-by-item basis compared to future usage and sales for obsolescence quarterly.

#### Property and Equipment

Property and equipment are recorded at cost. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets from three to forty years. Leasehold improvements are depreciated over the life of the related lease (including expected extensions) or asset, whichever is shorter. Amortization of assets acquired under capital leases is included in depreciation and amortization expense. Significant improvements extending the useful life of property are capitalized. When property is retired or otherwise disposed of, the cost of the property and the related accumulated depreciation are removed from the accounts, and any resulting gains or losses are reflected in the consolidated statements of operations. Repair and maintenance costs are expensed as incurred.

#### Computer Software Development Costs

In general, direct development costs associated with internal-use computer software are capitalized as fixed assets and include external direct costs of material and services and payroll costs for employees devoting time to the software projects, where applicable. Costs incurred during the preliminary project stage, as well as for maintenance and training, are expensed as incurred. Depreciation expense relative to capitalized computer software development costs was \$64,789 and \$52,099, for 2009 and 2008, respectively.

#### Long-Lived Assets

We review long-lived assets, including intangible assets subject to amortization, for possible impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable.

We assess the recoverability of such long-lived assets by determining whether the amortization of the balances over their remaining lives can be recovered through undiscounted future operating cash flows. The amount of impairment, if any, is measured based on projected discounted future operating cash flows. The assessment of the recoverability of long-lived assets will be impacted if estimated future operating cash flows are not achieved. We conducted an impairment test for property and equipment as of December 31, 2009 and concluded that the carrying value of these assets is recoverable through expected future operating cash flows.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

#### Income Taxes

Deferred tax assets and liabilities are recognized currently for the future tax consequences attributable to the temporary differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets if it is more likely than not that such assets will not be realized.

We consider all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a net deferred tax asset. Judgment is used in considering the relative impact of negative and positive evidence. In arriving at these judgments, the weight given to the potential effect of negative and positive evidence is commensurate with the extent to which it can be objectively verified. We record a valuation allowance to reduce our deferred tax assets and review the amount of such allowance annually. When we determine certain deferred tax assets are more likely than not to be utilized, we will reduce our valuation allowance accordingly.

#### Share-Based Payments

Employee stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. The fair value of each option grant is estimated at the date of grant using the Black-Scholes option valuation model. We make the following assumptions relative to this model: (i) the annual dividend yield is zero as we do not pay dividends, (ii) the weighted-average expected life is based on share option exercises, pre and post vesting terminations and share option term expiration, (iii) the risk free interest rate is based on the U.S. Treasury security rate for the expected life, and (iv) the volatility is based on the level of fluctuations in our historical share price for a period equal to the weighted-average expected life. We estimate forfeitures when recognizing compensation expense and adjust this estimate over the requisite service period should actual forfeitures differ from such estimates. Changes in estimated forfeitures are recognized through a cumulative adjustment, which is recognized in the period of change and which impacts the amount of unamortized compensation expense to be recognized in future periods.

#### Significant Concentrations and Risks

We maintain cash balances at a major bank and, at times, balances exceed FDIC limits. Substantially all of our accounts receivable are with agents or departments of the U. S. Federal Government which, although concentrated in one group of common entities, does not expose us to significant credit risk.

#### Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts

Billings in excess of costs and estimated earnings on uncompleted contracts consists of amounts for which contract billings have been presented but the goods and services required under the contracts have not yet been provided and the associated revenue has not been recognized.

#### Research and Development Costs

Research and development costs include experimentation, design, and enhancement of proprietary technologies and products and are expensed as incurred.

NOTE 2 – NEW ACCOUNTING STANDARDS

The FASB has issued Accounting Standards Update (“ASU”) 2009-04, “Accounting for Redeemable Equity Instruments”. ASU 2009-04 updates Topic 480-10-S99 to reflect the SEC staff’s view regarding the application of Accounting Series Release No. 268, Presentation in Financial Statements of “Redeemable Preferred Stocks”. The adoption of the standard is not expected to have a significant impact on our consolidated financial statements.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The FASB has issued Accounting Standards Update (“ASU”) 2009-13, “Multiple Deliverable Revenue Arrangements”. ASU 2009-13 replaces EITF 00-21, and clarifies the criteria for separating revenue between multiple deliverables. This statement is effective for new revenue arrangements or materially modified arrangements in periods subsequent to adoption. Adoption is required for fiscal years beginning on or after June 15, 2010, but early adoption is allowed. We anticipate adopting ASU 2009-13 as of January 1, 2010 for new commercial revenue arrangements that fall within the scope of this Update. The adoption of the standard is not expected to have a significant impact on our consolidated financial statements.

The FASB has issued Accounting Standards Update (“ASU”) 2009-14, “Certain Revenue Arrangements that Include Software Elements”. ASU 2009-14 changes the accounting model for revenue arrangements that included both tangible products and software elements. Under this guidance, tangible products containing software components and non-software components that function together to deliver the tangible product’s essential functionality are excluded from the software revenue guidance in Subtopic 985-605, Software-Revenue recognition. ASU 2009-14 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, which for us would be our fiscal year beginning January 1, 2011. Early adoption is permitted. The adoption of the standard is not expected to have a significant impact on our consolidated financial statements.

The FASB has issued Accounting Standards Update (“ASU”) 2010-06, “Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements.” This ASU requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. The FASB’s objective is to improve these disclosures and, thus increase the transparency in financial reporting. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, which for us would be our fiscal quarter beginning January 1, 2010. The adoption of the standard is not expected to have a significant impact on our consolidated financial statements.

### NOTE 3 - ACCOUNTS RECEIVABLE

Our accounts receivable balance as of December 31, 2009 and 2008 included contract receivables related to completed and in progress contracts, and costs and estimated earnings on uncompleted contracts. Costs and estimated earnings on uncompleted contracts represent amounts that are billable under the terms of contracts at the end of the year, were invoiced in the following year and are generally expected to be collected within a year.

Accounts receivable consist of the following as of December 31, 2009 and 2008:

|  | December 31, |              |
|--|--------------|--------------|
|  | 2009         | 2008         |
| Contracts receivable                                 | \$ 1,031,960 | \$ 1,677,929 |
| Cost and estimated earnings on uncompleted contracts | 42,984       | 1,049,924    |
| Accounts receivable, net                             | \$ 1,074,944 | \$ 2,727,853 |
| Short term receivable (contract retention)           | \$ 47,817    | \$ -         |
| Long term receivable (contract retention)            | 205,313      | 253,130      |
|  | \$ 1,328,074 | \$ 2,980,983 |

Contract and short term receivables at December 31, 2009 are expected to be collected within a year. There are no claims or unapproved change orders included in contract receivables at December 31, 2009 and 2008. The retained balances at December 31, 2009 and 2008 represent mandatory contract reserves for which customers have been billed.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Costs and Estimated Earnings on Uncompleted Contracts

|  | December 31,  |               |
|--|---------------|---------------|
|  | 2009          | 2008          |
| Costs incurred on uncompleted contracts  | \$ 18,890,642 | \$ 20,118,499 |
| Estimated earnings   | 1,479,680     | 1,564,814     |
| Total billable costs and estimated earnings  | \$ 20,370,322 | \$ 21,683,313 |
| Less:  |               |               |
| Billings to date   | 20,370,054    | 20,633,389    |
| Total  | \$ 268        | \$ 1,049,924  |
| Included in accompanying balance sheet:  |               |               |
| Unbilled costs and estimated earnings on uncompleted contracts included in accounts receivable | \$ 42,984     | \$ 1,049,924  |
| Billings in excess of costs and estimated earnings on uncompleted contracts                    | (42,716)      | -             |
| Total  | \$ 268        | \$ 1,049,924  |

NOTE 4 – INVENTORIES

Our inventories consist of the following at December 31, 2009 and 2008:

|                               | December 31, |            |
|-------------------------------|--------------|------------|
|                               | 2009         | 2008       |
| Raw materials                 | \$ 103,451   | \$ 124,849 |
| Work-in-process               | 704,028      | 32,340     |
| Provision for loss on project | (22,000)     | -          |
| Total inventory               | \$ 785,479   | \$ 157,189 |

Inventories include material, direct labor and related manufacturing administrative overhead and are stated at the lower-of-cost (determined on a weighted average basis) or market for raw materials and work-in-process inventory. When actual contract cost and the estimate to complete exceed the estimated contract revenues, a loss provision is recorded. Due to the nature of our inventory, we analyze inventory on an item-by-item basis compared to future usage and sales for obsolescence quarterly. As of December 31, 2009 and 2008, management does not believe an obsolescence reserve is necessary based on this analysis. Included in work-in-process inventory is an allocation of general and administrative cost of approximately \$52,000 as of December 31, 2009. There was no allocation of general and administrative cost included in work-in-process inventory as of December 31, 2008.





APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 5 – PROPERTY AND EQUIPMENT

Property and Equipment consist of the following as of December 31, 2009 and 2008:

|  | December 31,<br>2009 | December 31,<br>2008 |
|--|----------------------|----------------------|
| Land and buildings                             | \$ 2,072,215         | \$ 2,072,215         |
| Equipment                                      | 2,677,926            | 3,214,640            |
| Furniture and building improvements            | 858,379              | 1,107,245            |
| Software                                       | 800,566              | 787,331              |
| Total  | 6,409,086            | 7,181,431            |
| Less accumulated depreciation and amortization | (3,563,479)          | (3,657,790)          |
| Net property and equipment                     | \$ 2,845,607         | \$ 3,523,641         |

Included in 2008 property and equipment are assets under capitalized lease agreements with an aggregate cost of \$34,302, and related accumulated amortization of \$33,050 as of December 31, 2008. Amortization expense for these assets was \$1,252 and \$6,552 for the years ended December 31, 2009 and 2008, respectively. These capital leases were paid in full in 2009.

## NOTE 6 – INTANGIBLE ASSETS

Intangible assets consist of the following as of December 31, 2009 and 2008:

|   | As of December 31, 2009  |                             |                        |
|---|--------------------------|-----------------------------|------------------------|
|   | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Carrying<br>Amount |
| Intangible assets subject to amortization |                          |                             |                        |
| Patent                                    | \$ 34,000                | \$ 34,000                   | \$ -                   |
| Technological know-how                    | 212,000                  | 212,000                     | -                      |
| Intangible assets net                     | \$ 246,000               | \$ 246,000                  | \$ -                   |
|   | As of December 31, 2008  |                             |                        |
|   | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Carrying<br>Amount |
| Intangible assets subject to amortization |                          |                             |                        |
| Patent                                    | \$ 34,000                | \$ 28,900                   | \$ 5,100               |
| Technological know-how                    | 212,000                  | 180,200                     | 31,800                 |
| Intangible assets net                     | \$ 246,000               | \$ 209,100                  | \$ 36,900              |

Amortization expense related to amortizable intangibles was approximately \$37,000 and \$49,000 for the years ended December 31, 2009 and 2008, respectively.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 – STOCKHOLDERS' EQUITY

Preferred Stock

As of December 31, 2008 and 2009, there were 135,572 shares of Series A Redeemable Convertible Preferred Stock (the "Series A Preferred Stock") outstanding.

Our Series A Preferred Stock has a liquidation preference of \$25.00 per Share. The Series A Preferred Stock bears dividends at the rate of 6.5% of the liquidation preference per share per annum, which accrues from the date of issuance, and is payable quarterly, when declared. Dividends may be paid in: (i) cash, (ii) shares of our common stock (valued for such purpose at 95% of the weighted average of the last sales prices of our common stock for each of the trading days in the ten trading day period ending on the third trading day prior to the applicable dividend payment date), provided that the issuance and/or resale of all such shares of our common stock are then covered by an effective registration statement or (iii) any combination of the foregoing. If the Company fails to make a dividend payment within five business days following a dividend payment date, the dividend rate shall immediately and automatically increase by 1% from 6.5% of the liquidation preference per offered share of Series A preferred stock to 7.5% of such liquidation preference for as long as such failure continues and immediately return to 6.5% of the liquidation preference per share of Series A preferred stock per annum at such time as such failure no longer continues.

Each share of Series A Preferred Stock is convertible at any time at the option of the holder into a number of shares of common stock equal to the liquidation preference (plus any accrued and unpaid dividends for periods prior to the dividend payment date immediately preceding the date of conversion by the holder) divided by the conversion price (initially \$12.00 per share, subject to adjustment in the event of a stock dividend or split, reorganization, recapitalization or similar event.) If the closing sale price of the common stock is greater than 140% of the conversion price on 20 out of 30 trading days, the company may redeem the Series A Preferred Stock in whole or in part at any time through October 31, 2010, upon at least 30 days' notice, at a redemption price, payable in cash, equal to 100% of the liquidation preference of the shares to be redeemed, plus accrued and unpaid dividends thereon to, but excluding, the redemption date, subject to certain conditions. In addition, beginning November 1, 2010, the company may redeem the Series A Preferred Stock in whole or in part, upon at least 30 days' notice, at a redemption price, payable in cash, equal to 100% of the liquidation preference of the Series A Preferred Stock to be redeemed, plus accrued and unpaid dividends thereon to, but excluding, the redemption date, under certain conditions.

Dividends on our Preferred Stock are payable quarterly on the first day of February, May, August and November, in cash or shares of Common Stock, at our discretion. We declared and paid dividends on our 6.5% Series A Convertible Preferred Stock in May, August and November, 2008 and February, 2009. Portions of these dividends were paid in the form of common stock with the remaining paid in cash. Dividends on Preferred Stock are accrued when the amount of the dividend is declared. In order to reduce the amount of dividends payable, 5,151,000 shares of common stock were issued in exchange for 515,100 shares of preferred stock. Such exchange was determined to be an induced conversion and, as such, required \$3.3 million to be reported as a special dividend in 2008.

For the payment of dividends in 2009, we issued 294,464 shares of common stock with a market value of approximately \$113,000, and paid cash dividends of approximately \$129,000. For the payment of dividends in 2008, we issued 527,904 shares of common stock with a market value of approximately \$550,000, and paid cash dividends of approximately \$278,000, and not including cash dividends of approximately \$55,000 paid February 1, 2009.



APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Share-Based Payments

Applied Energetics adopted an Amended and Restated 2007 Stock Incentive Plan (“2007 Plan”) and a 2004 Stock Incentive Plan as amended (“2004 Plan”) both of which provides for the grant of any or all of the following types of awards: (1) stock options, (2) restricted stock, (3) deferred stock, (4) stock appreciation rights, and (5) other stock-based awards, including restricted stock units, for periods up to 10 years. Stock options granted under the plans are generally for a fixed number of shares to employees and directors with an exercise price equal to the fair market value of the shares at the date of grant. Options granted to employees will generally vest over two to four years. All options granted have a contractual life of 5 years from the grant date. Restricted stock granted under the plans to employees generally vest immediately and/or over a period of up to four years. Some restricted stock granted under the plans vest only upon meeting certain departmental or company-wide performance goals. Both restricted stock and options granted to non-employee directors generally vest immediately on the date of grant. We have, from time to time, also granted non-plan options to certain officers, directors and employees. Total stock-based compensation expense for grants to officers, directors, employees and consultants was approximately \$1.8 million and \$3.7 million for the years ended December 31, 2009 and 2008, respectively, which was charged to general and administrative expense.

At December 31, 2009 and 2008, there were outstanding options to purchase 4.5 million and 4.8 million, respectively, of common stock. We also had outstanding warrants to purchase 1.0 million and 1.1 million shares of common stock for the same respective dates. Additionally, as of December 31, 2009 and 2008, respectively, there were 224,142 and 984,177 unvested restricted stock units and grants outstanding.

On June 28, 2005, our stockholders approved an amendment to the company's 2004 Plan to (i) increase the number of shares of the company's common stock, \$.001 par value, authorized for issuance under the 2004 Plan by 2,000,000 shares from 3,000,000 shares to 5,000,000 shares, and (ii) set the maximum number of shares of Common Stock which may be issued upon the exercise of incentive stock options at 3,000,000 shares. As of December 31, 2009 and 2008, options to purchase 4,063,944 and 3,684,223 shares, respectively, were outstanding under this plan. Additionally, as of December 31, 2009 and 2008, respectively, there were 112,507 and 298,166 unvested restricted stock units outstanding under this plan.

On September 10, 2007, the stockholders of Applied Energetics approved the adoption of the company's 2007 Plan. A total of 10,000,000 shares of common stock have been reserved for distribution pursuant to the 2007 Plan; provided, however, that the maximum number of shares available for award or grant during the first five years of the 2007 Plan shall be an aggregate of 5,000,000 shares; and provided further that the maximum number of shares available for award or grant during any consecutive twelve month period shall be 1,000,000 shares during the first two years of the 2007 Plan and 2,000,000 shares during the third through fifth years of the 2007 Plan. As of December 31, 2009 and 2008, options to purchase 429,688 and 25,000 shares, respectively, were outstanding under this plan. There was no unvested restricted stock outstanding as of December 31, 2009. There were 636,011 shares of unvested restricted stock outstanding as of December 31, 2008 under this plan. Grants from the 2007 Plan can be either service based, where the grant vests with the passage of time, or performance based, where the grant vests based on the attainment of a pre-defined company or departmental goal.

There are 8,807,153 aggregate shares available for issuance from the Stock Incentive Plans, of which 2,867,153 are available for grant as of December 31, 2009.

The fair value of Restricted Stock and Restricted Stock Units was estimated using the closing price of our Common Stock on the date of award and fully recognized upon vesting.

The fair value of option awards was estimated using the Black-Scholes option pricing model with the following assumptions and weighted average fair values:

|  | For the year ended December 31, |              |
|--|---------------------------------|--------------|
|  | 2009                            | 2008         |
| Weighted average grant date fair value of grants | \$ 0.45                         | \$ 1.36      |
| Expected volatility                              | 93.56%                          | 67.25%       |
| Expected dividends                               | 0%                              | 0%           |
| Expected term (years)                            | 2.5 -<br>3.0                    | 2.5 -<br>3.0 |
| Risk free rate                                   | 1.15% -<br>1.44%                | 2.24%        |

APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the activity of our stock options for the years ended December 31, 2008 and 2009:

|                                  | Shares      | Weighted<br>Average<br>Exercise Price |
|----------------------------------|-------------|---------------------------------------|
| Outstanding at December 31, 2007 | 5,112,036   | \$ 6.37                               |
| Granted                          | 75,000      | \$ 2.65                               |
| Exercised                        | -           | \$ 0.00                               |
| Forfeited or expired             | (354,188)   | \$ 6.83                               |
| Outstanding at December 31, 2008 | 4,832,848   | \$ 6.30                               |
| Granted                          | 6,084,957   | \$ 0.45                               |
| Exercised                        | (83,333)    | \$ 0.48                               |
| Forfeited or expired             | (6,326,590) | \$ 4.91                               |
| Outstanding at December 31, 2009 | 4,507,882   | \$ 0.47                               |
| Exercisable at December 31, 2009 | 2,957,213   | \$ 0.51                               |

As of December 31, 2009 and 2008, the aggregate intrinsic value (amount by which Applied Energetics' closing stock price on the last trading day of the year exceeds the exercise price of the option) of options outstanding as well as options exercisable was \$0 as no options were in-the-money. The intrinsic value of options exercised was \$0.48. As of December 31, 2009 and 2008, the weighted average remaining contractual life of options outstanding and options exercisable was 3.54 and 2.19 years, respectively. At December 31, 2009, there was approximately \$255,000 of unrecognized compensation costs related to unvested stock options, net of estimated forfeitures. The cost is expected to be recognized on a weighted-average basis over a period of approximately 1.64 years.

On February 5, 2009, we commenced an exchange offer pursuant to which we offered our employees and members of the Board of Directors the opportunity to exchange options to purchase shares of our common stock outstanding under our 2004 Stock Incentive Plan for new options. In exchange for the cancellation of the outstanding options, we offered to issue new options equal to fifty percent (50%) of the number of shares subject to the cancelled options. The new options, which were granted under the 2004 Stock Incentive Plan as non-qualified options, vested immediately upon the date of the grant and are exercisable at \$0.50 per share for a three (3) year period from the date of grant. We accepted for exchange and cancelled eligible options to purchase an aggregate of 3,502,536 shares of our common stock on March 6, 2009. Subject to the terms and conditions of the offer, on March 9, 2009, we granted new options to purchase 1,751,269 shares of our common stock in exchange for the eligible options validly tendered and accepted for exchange and cancelled. The exchange and cancellation was accounted for as a modification of the terms of the cancelled awards. The new options vested immediately, therefore all remaining unrecognized compensation cost of the original option issuances (for unvested options) plus incremental cost of the exchange and cancellation was recognized during the first quarter of 2009, which was approximately \$402,000.



APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the activity of our restricted stock units and restricted stock grants for the years ended December 31, 2009 and 2008:

|                               | Shares    | Weighted Average Grant<br>Date<br>Fair Value |
|-------------------------------|-----------|--|
| Unvested at December 31, 2007 | 1,357,950 | \$ 3.27                                      |
| Granted                       | 280,434   | \$ 1.86                                      |
| Vested                        | (601,531) | \$ 2.94                                      |
| Forfeited                     | (52,676)  | \$ 2.40                                      |
| Unvested at December 31, 2008 | 984,177   | \$ 3.12                                      |
| Granted                       | 136,500   | \$ 0.33                                      |
| Vested                        | (586,708) | \$ 2.78                                      |
| Forfeited                     | (309,827) | \$ 2.57                                      |
| Unvested at December 31, 2009 | 224,142   | \$ 3.06                                      |

As of December 31, 2009 and 2008, there was approximately \$335,000 and \$2.1 million, respectively, of unrecognized stock-based compensation related to unvested restricted stock awards, net of estimated forfeitures, which we expect to recognize over a weighted-average period of 0.84 years. Of the 224,142 restricted stock units and restricted stock grants unvested at December 31, 2009, 211,612 will vest based solely on the continued employment of the grantee, and 12,530 will vest on the achievement of certain named departmental objectives.

Compensation expense recorded for shares and options delivered to non-employees for the years ended December 31, 2009 and 2008 was approximately \$22,150 and \$80,725, respectively, which was charged to operating expenses with offsetting entries to additional paid-in capital or pre-paid assets.

#### Warrants

In October 2005, we issued 101,667 warrants as compensation for agency services provided in the issuance of our Preferred Stock financing. The warrants are exercisable for a period of five (5) years at an exercise price of \$12.00 per warrant share. In August 2006, as a part of our sale of 4,616,327 shares of our common stock we issued 923,272 warrants to purchase our common stock. The warrants are exercisable for a period of five (5) years at an exercise price of \$9.15 per warrant share.

Warrant activity is summarized as follows:

|  | Shares    | Weighted Average<br>Exercise Price | Weighted Average<br>Remaining<br>Contractual Term<br>(years) |
|--|-----------|------------------------------------|--|
| Outstanding and Exercisable at December 31, 2007 | 1,141,605 | \$ 8.86                            |  |

|  |           |    |      |      |
|--|-----------|----|------|------|
| Warrants Exercised                               | -         |    |      |      |
| Outstanding and Exercisable at December 31, 2008 | 1,141,605 | \$ | 8.86 |      |
| Warrants Exercised                               | -         |    |      |      |
| Warrants Expired                                 | (116,666) | \$ | 3.87 |      |
| Outstanding and Exercisable at December 31, 2009 | 1,024,939 | \$ | 9.43 | 1.53 |

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8 – SIGNIFICANT CUSTOMERS

The majority of our customers are either the Government or contractors to the Government and represent 97% and 87% of revenue for 2009 and 2008, respectively. Government sourced customers represent approximately 90% and 78% of our account receivable as of December 31, 2009 and 2008, respectively.

NOTE 9 – RETIREMENT PLAN

We established a 401(k) plan for the benefit of our employees. Employees are eligible to contribute to their 401(k) accounts through payroll deductions. We implemented an employer match benefit effective January 1, 2007, where we match 50% of the employees' 401(k) contribution up to 3% of their eligible compensation. The employer match expense was approximately \$106,000 and \$156,000 in 2009 and 2008, respectively. The assets of the plan are held by a third party trustee. Plan participants may direct the investment of their funds among one or more of the investment choices available to participants.

NOTE 10 – COMMITMENTS AND CONTINGENCIES

Operating Leases

In Tucson, Arizona, we lease office, manufacturing and storage space under three non-cancellable operating lease agreements. On February 6, 2008, we entered into an agreement to purchase our principal office, manufacturing, storage, and primary research and development facility from Columbia Tucson, LLC ("CT"), which we previously leased from CT. The purchase price of the Property was approximately \$2.2 million, which approximated fair value. The fair value of the real estate purchased was reasonably and objectively determined, the real estate had been held by CT for a period of more than five years and was of the type that could be expected to appreciate in value. CT has no continuing involvement or ownership in the real estate after the sale. Joseph Hayden and Steven McCahon, executive officers, Robert Howard and Thomas Dearmin, principal stockholders and former executive officers and directors, another former executive officer and certain family members of Mr. Howard own all of the membership interests of CT. During 2008, we paid rent of approximately \$39,000 to CT for the use of this property. Upon completion of the purchase transaction, the lease obligations as described were terminated.

In February 2006, we consolidated our executive and administrative offices into one location, which is proximate to our Tucson research and development facility. Effective December 2006, we entered into a lease agreement for this property and we exercised our option to extend this lease to January 2010 with monthly rents of approximately \$7,000 accelerating to approximately \$7,400 in the final year of the lease.

In June, 2007, we commenced a 3-year non-cancelable, renewable operating lease in Earth City, MO, at a monthly rent of approximately \$6,000. We are also responsible for certain property related costs, including insurance, utilities and property taxes. This facility is idle, and the expected remaining rent has been included in the 2009 rent expense figure. We have vacated this property and our last lease payment is due in May of 2010.

In November, 2009, we commenced a 2-year non-cancelable, renewable operating lease in Tucson, Arizona, at a monthly rent of approximately \$9,000. We are also responsible for certain property related costs, including insurance, utilities and property taxes.

Rent expense was approximately \$390,000 and \$457,000 for 2009 and 2008, respectively.



APPLIED ENERGETICS, INC.  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Future annual minimum lease payments at December 31, 2009 under these operating lease agreements are as follows:

| Years ending December 31, | Amount     |
|---------------------------|------------|
| 2010                      | \$ 115,891 |
| 2011                      | 99,462     |
| Total                     | \$ 215,353 |

Guarantees

We agree to indemnify our officers and directors for certain events or occurrences arising as a result of the officers or directors serving in such capacity. The maximum amount of future payments that we could be required to make under these indemnification agreements is unlimited. However, we maintain a director's and officer's liability insurance policy that limits our exposure and enables us to recover a portion of any future amounts paid. As a result, we believe the estimated fair value of these indemnification agreements is minimal because of our insurance coverage and we have not recognized any liabilities for these agreements as of December 31, 2009 and 2008.

Litigation

We may from time to time be involved in legal proceedings arising from the normal course of business. Please see Note 14.

APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 11 – INCOME TAXES

The reconciliation of the difference between income taxes at the statutory rate and the income tax provision for the years ended December 31, 2009 and 2008 is as follows:

|   | December 31 ,  |                |
|---|----------------|----------------|
|   | 2009           | 2008           |
| Computed tax at statutory rate          | \$ (3,207,449) | \$ (2,964,672) |
| State taxes                             | (359,844)      | (555,919)      |
| Change in valuation allowance           | 2,178,113      | 3,283,073      |
| SFAS 123(R) restricted stock shortfalls | 477,482        | 229,115        |
| Other                                   | 911,698        | 8,403          |
| Provision (benefit) for taxes           | \$ -           | \$ -           |

Deferred tax assets (liabilities) consist of the following:

|                                     | December 31 , |              |
|-------------------------------------|---------------|--------------|
|                                     | 2009          | 2008         |
| <b>Deferred Tax Assets:</b>         |               |              |
| Accruals and reserves               | \$ 84,246     | \$ 267,790   |
| Depreciation and amortization       | 394,587       | 359,533      |
| Tax credit carryforwards            | 847,895       | 847,895      |
| Net operating loss                  | 17,000,187    | 13,660,498   |
| Goodwill amortization               | 396,836       | 437,135      |
| SFAS 123(R) stock compensation NQSO | 3,036,875     | 4,009,662    |
| Valuation allowance                 | (21,760,626)  | (19,582,513) |
| Total deferred tax assets           | \$ -          | \$ -         |

We believe that sufficient uncertainty exists regarding the future realization of our deferred tax assets and thus a full valuation allowance is required. The valuation allowance for the year ended December 31, 2009 increased by approximately \$3.2 million due to changes in deferred tax assets.

As of December 31, 2009, we have cumulative federal and Arizona net operating loss carryforwards of approximately \$76 million and \$45 million, respectively, which can be used to offset future income subject to taxes. Federal net operating loss carryforwards begin to expire in 2020. Arizona net operating loss carryforwards begin to expire in 2010. Included in federal net operating loss carryforwards is approximately \$27.1 million from USHG related to pre-merger losses. In addition, approximately \$7 million of the federal net operating loss carryforwards are related to stock based compensation that will be credited to additional paid in capital when realized. We also have pre-merger federal capital loss carryforwards of approximately \$520,000.

As of December 31, 2009, we had cumulative unused research and development tax credits of approximately \$435,000 and \$413,000 which can be used to reduce future federal and Arizona income taxes, respectively. As of December 31, 2009, we have cumulative unused federal minimum tax credit carryforwards from USHG of

approximately \$244,000. The federal minimum tax credit carryforwards are not subject to expiration under current federal tax law.

Utilization of our USHG pre-merger net operating loss carryforwards and tax credits is subject to substantial annual limitations due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carryforwards and tax credit carryforwards before utilization.

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

We had unrecognized tax benefits attributable to losses and minimum tax credit carryforwards that were incurred by USHG prior to the merger in March 2004 as follows:

|  |              |
|--|--------------|
| Balance at December 31, 2007                                   | \$ 9,635,824 |
| Additions related to prior year tax positions                  | -            |
| Additions related to current year tax positions                | -            |
| Reductions related to prior year tax positions and settlements | -            |
| Balance at December 31, 2008                                   | 9,635,824    |
| Additions related to prior year tax positions                  | -            |
| Additions related to current year tax positions                | -            |
| Reductions related to prior year tax positions and settlements | -            |
| Balance at December 31, 2009                                   | \$ 9,635,824 |

These benefits are not recognized as a result of uncertainty regarding the utilization of the loss carryforwards and minimum tax credits. If in the future we utilize the attributes and resolve the uncertainty in our favor, the full amount will favorably impact our effective income tax rate.

The company considers the U.S. and Arizona to be major tax jurisdictions. As of December 31, 2009, for federal tax purposes the tax years 1999 through 2009 and for Arizona the tax years 2005 through 2009 remain open to examination. The company currently does not expect any material changes to unrecognized tax positions within the next twelve months.

We recognize interest and penalties related to unrecognized tax benefits in income tax expense. As of December 31, 2009, we had no accrued interest or penalties related to our unrecognized tax benefits.



APPLIED ENERGETICS, INC.  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – SUPPLEMENTAL CASH FLOW INFORMATION

|  | Year Ended December 31, |           |
|--|-------------------------|-----------|
|  | 2009                    | 2008      |
| Cash paid during the year for:               |                         |           |
| Interest                                     | \$ 1,131                | \$ 2,099  |
| Non-Cash investing and financing activities: |                         |           |
| Conversion of Series A Preferred Stock       | -                       | 5,232,935 |

APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 13 – QUARTERLY OPERATING RESULTS (UNAUDITED)

Quarterly operating results for 2009 and 2008 were as follows:

|  | 1st            | 2nd            | 3rd            | 4th            |
|--|----------------|----------------|----------------|----------------|
| <b>2009</b>  |                |                |                |                |
| Revenues   | \$ 2,587,398   | \$ 1,730,141   | \$ 1,877,865   | \$ 1,264,404   |
| Gross profit   | 185,952        | 98,825         | 100,025        | 67,083         |
| Operating loss   | (3,005,455)    | (3,240,224)    | (1,591,732)    | (1,658,315)    |
| Net loss attributable to common stockholders                     | \$ (3,029,523) | \$ (3,278,493) | \$ (1,660,285) | \$ (1,710,168) |
| Weighted average number of shares outstanding, basic and diluted | 86,444,383     | 86,137,728     | 86,179,071     | 88,968,812     |
| Basic and diluted net loss per share                             | \$ (0.04)      | \$ (0.04)      | \$ (0.02)      | \$ (0.02)      |
| <b>2008</b>  |                |                |                |                |
| Revenues   | \$ 1,961,090   | \$ 5,677,998   | \$ 4,014,302   | \$ 4,960,821   |
| Gross profit (loss)  | 220,982        | 488,544        | 224,340        | (194,473)      |
| Operating loss   | (3,545,004)    | (984,859)      | (1,844,398)    | (2,980,747)    |
| Net loss attributable to common stockholders                     | \$ (3,591,570) | \$ (1,101,538) | \$ (1,998,502) | \$ (6,244,846) |
| Weighted average number of shares outstanding, basic and diluted | 80,404,613     | 80,594,626     | 80,628,098     | 81,528,544     |
| Basic and diluted net loss per share                             | \$ (0.04)      | \$ (0.01)      | \$ (0.02)      | \$ (0.08)      |

During the first half of 2009, certain LGE contracts were completed which led to reduced revenues in the second half of 2009. Additionally, two new LGE contracts were announced in the second half of the year. The additional decrease in revenues of \$613,000 from the third quarter to the fourth quarter of 2009 was due to delays in our contract negotiation for our CIED product line. A new contract modification for \$10.4 million was signed in January, 2010. Throughout 2009, the company was focused on cost reduction initiatives that included building consolidations, reduced operating expenses, and headcount reductions; which improved our labor and operational efficiencies to minimize our cash usage and reduce our operating loss.

During the second quarter of 2008, the company secured a CIED contract with the U. S. Marines of approximately \$9.0 million, which led to increased revenues for the second and third quarter from this product line. During the third and fourth quarters of 2008, the ARDEC contract received from the U. S. Army of approximately \$4.5 million began to ramp up as the CIED revenue leveled off. During the fourth quarter of 2008, our HV product line completed various contracts amounting to \$1.8 million in revenues, which relieved inventory. Additionally, in the fourth quarter of 2008, the company wrote off obsolete CIED equipment amounting to a charge of approximately \$561,000, which further relieved inventories.

NOTE 14 – SUBSEQUENT EVENTS

We were awarded a \$10.4 million contract from the U.S. Marine Corps. The contract funds will support field operational support for deployed systems, training of U.S. Marines, procurement of additional systems, development of improvements to allow installation of the system on additional Marine Corps and U.S. Army vehicles, and an engineering package to facilitate future transition of the system to Low Rate Initial Production (LRIP).

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APPLIED ENERGETICS, INC.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

On February 1, 2010, Applied Energetics, Inc. received notice that NewOak Capital Markets, LLC (“NewOak”), formerly known as J. Giordano Securities, LLC, the placement agent for the company’s October, 2005 private placement of preferred stock, had commenced an arbitration proceeding against the company with Financial Industry Regulatory Authority (“FINRA”). NewOak alleges that the company made material misrepresentations between May 2005 and May 10, 2006 concerning the status of its products.

The company previously settled class action and derivative lawsuits relating to the alleged misrepresentations. NewOak, however, opted out of the class action and alleges that the alleged misrepresentations constituted breaches of its agreement with the company and that the company breached warranties it made to NewOak in connection with the 2005 private placement. NewOak seeks indemnification and recovery for alleged breach of contract, unjust enrichment, quantum meruit, fraudulent misrepresentation, tortious interference with prospective economic relations and violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and seeks an award of monetary damages in excess of \$10 million, plus punitive damages and attorney’s fees and costs.

The company intends to defend itself vigorously in any arbitration or legal proceedings and believes it has substantial defenses to the claims.

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