

APPLIED ENERGETICS, INC.  
Form 10-Q  
August 09, 2010

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2010

OR

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

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

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

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

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

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(Do not check if a smaller reporting  
company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date. As of August 5, 2010, there were 90,599,186 shares of the issuer's common stock, par value \$.001 per share, outstanding.

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QUARTERLY REPORT ON FORM 10-Q  
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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

APPLIED ENERGETICS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

|  | June 30, 2010<br>(Unaudited) | December 31,<br>2009 |
|--|------------------------------|----------------------|
| <b>ASSETS</b>  |                              |                      |
| Current assets   |                              |                      |
| Cash and cash equivalents  | \$ 8,928,536                 | \$ 9,604,643         |
| Short term investments   | 225,000                      | 225,000              |
| Accounts receivable  | 1,959,413                    | 1,074,944            |
| Inventory  | 740,059                      | 785,479              |
| Prepaid expenses and deposits  | 145,091                      | 447,295              |
| Other receivables  | 53,589                       | 52,295               |
| Total current assets   | 12,051,688                   | 12,189,656           |
| Long term receivables - net  | 205,313                      | 205,313              |
| Property and equipment - net   | 2,625,718                    | 2,845,607            |
| Other assets   | 20,800                       | 20,800               |
| <b>TOTAL ASSETS</b>  | <b>\$ 14,903,519</b>         | <b>\$ 15,261,376</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                              |                      |
| Current liabilities  |                              |                      |
| Accounts payable   | \$ 579,423                   | \$ 428,413           |
| Estimated loss on uncompleted contract   | 15,154                       | -                    |
| Accrued expenses   | 479,238                      | 313,448              |
| Short term financing   | 53,709                       | 214,834              |
| Accrued compensation   | 470,231                      | 505,188              |
| Customer deposits  | 149,120                      | 104,160              |
| Billings in excess of costs  | 3,592                        | 42,716               |
| Total current liabilities  | 1,750,467                    | 1,608,759            |
| Total liabilities  | 1,750,467                    | 1,608,759            |
| Commitments and contingencies  |                              |                      |
| Stockholders' equity   |                              |                      |
| Series A Convertible Preferred Stock, \$.001 par value, 2,000,000 shares authorized; 134,572 shares issued and outstanding at June 30, 2010 and 135,572 shares issued and outstanding at December 31, 2009 | 135                          | 136                  |
| Common stock, \$.001 par value, 125,000,000 shares authorized; 90,568,061 shares issued and outstanding at June 30, 2010 and 88,968,812 shares issued and outstanding at December 31, 2009                 | 90,561                       | 88,969               |
| Additional paid-in capital   | 78,187,809                   | 76,931,065           |
| Accumulated deficit  | (65,125,453)                 | (63,367,553)         |

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|   |                      |                      |
|---|----------------------|----------------------|
| Total stockholders' equity                        | 13,153,052           | 13,652,617           |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 14,903,519</b> | <b>\$ 15,261,376</b> |

See accompanying notes to condensed consolidated financial statements (unaudited)

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APPLIED ENERGETICS, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

|   | For the three months ended<br>June 30, |                |
|---|--|----------------|
|   | 2010                                   | 2009           |
| Revenue   | \$ 2,879,932                           | \$ 1,730,141   |
| Cost of revenue   | 2,794,693                              | 1,631,316      |
| Gross profit  | 85,239                                 | 98,825         |
| Operating expenses  |  |                |
| General and administrative  | 525,354                                | 2,825,062      |
| Selling and marketing   | 232,699                                | 191,001        |
| Research and development  | 3,658                                  | 322,986        |
| Total operating expenses  | 761,711                                | 3,339,049      |
| Operating loss  | (676,472)                              | (3,240,224)    |
| Other (expense) income  |  |                |
| Interest expense  | (1,667)                                | -              |
| Interest income   | 2,110                                  | 16,807         |
| Total other   | 443                                    | 16,807         |
| Net loss  | (676,029)                              | (3,223,417)    |
| Preferred stock dividends   | (57,557)                               | (55,076)       |
| Deemed dividend from induced conversion of Series A Preferred Stock | (11,478)                               | -              |
| Net loss attributable to common stockholders                        | \$ (745,064)                           | \$ (3,278,493) |
| Net loss per common share – basic and diluted                       | \$ (0.01)                              | \$ (0.04)      |
| Weighted average number of shares outstanding, basic and diluted    | 89,687,321                             | 86,137,728     |

See accompanying notes to condensed consolidated financial statements (unaudited)

APPLIED ENERGETICS, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

|   | For the six months ended<br>June 30, |                |
|---|--------------------------------------|----------------|
|   | 2010                                 | 2009           |
| Revenue   | \$ 6,474,709                         | \$ 4,317,539   |
| Cost of revenue   | 6,163,369                            | 4,032,763      |
| Gross profit  | 311,340                              | 284,776        |
| Operating expenses  |                                      |                |
| General and administrative  | 1,602,586                            | 5,260,785      |
| Selling and marketing   | 304,353                              | 429,024        |
| Research and development  | 36,520                               | 840,647        |
| Total operating expenses  | 1,943,459                            | 6,530,456      |
| Operating loss  | (1,632,119)                          | (6,245,680)    |
| Other (expense) income  |                                      |                |
| Interest expense  | (3,334)                              | (19)           |
| Interest income   | 4,572                                | 47,834         |
| Total other   | 1,238                                | 47,815         |
| Net loss  | (1,630,881)                          | (6,197,865)    |
| Preferred stock dividends   | (115,541)                            | (110,152)      |
| Deemed dividend from induced conversion of Series A Preferred Stock | (11,478)                             | -              |
| Net loss attributable to common stockholders                        | \$ (1,757,900)                       | \$ (6,308,017) |
| Net loss per common share – basic and diluted                       | \$ (0.02)                            | \$ (0.07)      |
| Weighted average number of shares outstanding, basic and diluted    | 89,281,990                           | 86,201,037     |

See accompanying notes to condensed consolidated financial statements (unaudited)

APPLIED ENERGETICS, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | For the six months ended<br>June 30, |                |
|---|--------------------------------------|----------------|
|   | 2010                                 | 2009           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |                                      |                |
| Net loss  | \$ (1,630,881)                       | \$ (6,197,865) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                      |                |
| Depreciation and amortization   | 216,600                              | 389,351        |
| Loss on equipment disposal  | 5,726                                | 105,841        |
| Provision for inventory reserves  | 15,154                               | -              |
| Provision for losses on projects  | 22,000                               | 22,000         |
| Non-cash stock based compensation expense                                   | 658,139                              | 1,098,923      |
| Changes in assets and liabilities:  |                                      |                |
| Accounts receivable   | (884,469)                            | 1,545,383      |
| Insurance receivable  | -                                    | (5,641,907)    |
| Other receivable  | (1,294)                              | (264,637)      |
| Inventory   | 23,420                               | (234,056)      |
| Prepaid expenses and deposits   | 302,204                              | 306,852        |
| Long term receivables - net   | -                                    | 253,129        |
| Accounts payable  | 151,010                              | (453,655)      |
| Litigation settlement liability   | -                                    | 5,525,000      |
| Billings in excess of costs   | (39,124)                             | 21,533         |
| Accrued expenses, customer deposits and deferred rent                       | 14,668                               | 1,401,510      |
| Net cash (used in) operating activities                                     | (1,146,847)                          | (2,122,598)    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |                                      |                |
| (Purchase)/disposal of land, building and equipment                         | (16,498)                             | 2,807          |
| Proceeds from disposal of equipment   | 14,061                               | 460            |
| Net cash (used in)/provided by investing activities                         | (2,437)                              | 3,267          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                |                                      |                |
| Dividends paid (preferred stock)  | -                                    | (110,152)      |
| Exercise of stock options   | 473,177                              | -              |
| Principal payments on capital lease obligations                             | -                                    | (2,028)        |
| Net cash (used in)/provided by financing activities                         | 473,177                              | (112,180)      |
| Net decrease in cash and cash equivalents                                   | (676,107)                            | (2,231,511)    |
| Cash and cash equivalents, beginning of period                              | 9,604,643                            | 15,467,386     |
| Cash and cash equivalents, end of period                                    | \$ 8,928,536                         | \$ 13,235,875  |

See accompanying notes to condensed consolidated financial statements (unaudited)





APPLIED ENERGETICS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying interim unaudited condensed consolidated financial statements include the accounts of Applied Energetics, Inc. and its wholly owned subsidiaries, Ionatron Technologies, Inc. and North Star Power Engineering, Inc. as of June 30, 2010 (collectively, "company," "Applied Energetics," "we," "our" or "us"). All intercompany balances and transactions have been eliminated. In the opinion of management, all adjustments (which include normal recurring adjustments) necessary for a fair presentation of the results for the interim periods presented have been made. The results for the six month period ended June 30, 2010, may not be indicative of the results for the entire year. The interim unaudited condensed consolidated financial statements should be read in conjunction with the company's audited consolidated financial statements contained in our Annual Report on Form 10-K.

The following unaudited condensed financial statements are presented pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the company believes that the disclosures made are adequate to make the information not misleading.

USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with United States Generally Accepted Accounting Principles ("GAAP") 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 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, estimating costs at completion on a contract, the valuation of inventory, and expected forfeiture rate on stock-based compensation.

CASH AND CASH EQUIVALENTS

We consider all highly liquid investments with maturities of three months or less to be cash equivalents. At June 30, 2010, we had approximately \$8.9 million of cash and cash equivalents.

FAIR VALUE OF FINANCIAL INSTRUMENTS

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

RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board ("FASB") has issued Accounting Standards Update ("ASU") No. 2010-12, "Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts" ("ASU 2010-12"), which clarifies the effect, if any, that the different signing dates of the Patient Protection and Affordable Care Act (signed March 23, 2010) and the Health Care and Education Reconciliation Act of 2010 (signed March 30, 2010). ASU 2010-12 was effective for us upon issuance. The adoption of the standard is not expected to have a significant impact on the company's consolidated financial statements.

The FASB has issued ASU 2010-13, "Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades". ASU 2010-13 clarifies that a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award should not be classified as a liability if it otherwise qualifies as equity. ASU 2010-13 will be effective for us beginning January 2011. The adoption of the standard is not expected to have a significant impact on the company's consolidated financial statements.

APPLIED ENERGETICS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)

## 2. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

|   | June 30, 2010 | December 31,<br>2009 |
|---|---------------|----------------------|
| Contracts receivable                                  | \$ 1,949,153  | \$ 1,031,960         |
| Costs and estimated earnings on uncompleted contracts | 10,260        | 42,984               |
| Accounts receivable, net                              | \$ 1,959,413  | \$ 1,074,944         |
| Short term receivable (contract retention)            | 47,817        | 47,817               |
| Long term receivable (contract retention)             | 205,313       | 205,313              |
|   | \$ 2,212,543  | \$ 1,328,074         |

Contracts receivable are expected to be collected within a year.

| Costs and Estimated Earnings on Uncompleted Contracts  |               |                   |
|--|---------------|-------------------|
|  | June 30, 2010 | December 31, 2009 |
| Costs incurred on uncompleted contracts  | \$ 24,998,335 | \$ 18,890,642     |
| Estimated earnings   | 1,822,076     | 1,479,680         |
| Total billable costs and estimated earnings  | 26,820,411    | 20,370,322        |
| Less:  |               |                   |
| Billings to date   | 26,813,743    | 20,370,054        |
| Total  | \$ 6,668      | \$ 268            |
| Included in accompanying balance sheet:  |               |                   |
| Unbilled costs and estimated earnings on uncompleted contracts included in accounts receivable | \$ 10,260     | \$ 42,984         |
| Billings in excess of costs and estimated earnings on uncompleted contracts                    | (3,592)       | (42,716)          |
| Total  | \$ 6,668      | \$ 268            |

APPLIED ENERGETICS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)

### 3. INVENTORY

Our inventories consist of the following:

|                               | June 30,<br>2010  | December 31,<br>2009 |
|-------------------------------|-------------------|----------------------|
| Raw materials                 | \$ 95,901         | \$ 103,451           |
| Work-in-process               | 688,158           | 704,028              |
| Provision for loss on project | (44,000)          | (22,000)             |
| <b>Total</b>                  | <b>\$ 740,059</b> | <b>\$ 785,479</b>    |

### 4. PROPERTY AND EQUIPMENT

Our property and equipment consist of the following:

|  | June 30, 2010       | December 31,<br>2009 |
|--|---------------------|----------------------|
| Land and buildings                             | \$ 2,072,215        | \$ 2,072,215         |
| Equipment                                      | 2,266,199           | 2,677,926            |
| Furniture and building improvements            | 843,464             | 858,379              |
| Software                                       | 800,566             | 800,566              |
| <b>Total</b>                                   | <b>5,982,443</b>    | <b>6,409,086</b>     |
| Less accumulated depreciation and amortization | (3,356,725)         | (3,563,479)          |
| <b>Net property and equipment</b>              | <b>\$ 2,625,718</b> | <b>\$ 2,845,607</b>  |

Periodically, we evaluate general impairment of assets. As an element of our annual business planning process conducted in the fourth quarter of each year, we consider expected revenues and resulting cash flow from operations. Revenue planning is based upon actual and expected contract awards as the majority of our revenues are sourced from Government contracts. During this process, we evaluate the current carrying values of all long-lived assets on our books. We compare these values against business plans to determine if carrying values are recoverable.

Our most recent asset impairment test was performed on February 15, 2010, when we determined that as of December 31, 2009 the net book values of long-lived assets were recoverable through expected undiscounted business cash flows based on anticipated and actual future revenue bookings and backlog. We will continue to evaluate the carrying values in the future. We evaluate impairments as such circumstances warrant.



APPLIED ENERGETICS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)

## 5. SHARE-BASED COMPENSATION

### Share-Based Compensation – Employees and Directors

For the three months ended June 30, 2010 and 2009, share-based compensation expense totaled \$132,000 and \$221,000, respectively. For the six months ended June 30, 2010 and 2009, share-based compensation expense totaled \$658,000 and \$1.1 million, respectively.

There was no related income tax benefit recognized because our deferred tax assets are fully offset by a valuation allowance.

As of June 30, 2010, \$202,000 of total unrecognized compensation cost related to restricted stock is expected to be recognized over a weighted average period of approximately .42 years.

The compensation committee granted options to purchase an aggregate of 50,000 shares of our common stock during the three months ended June 30, 2010 to a new employee. The options are exercisable at a price per share of \$1.23 and expire on May 21, 2015. One-third of the options became exercisable on May 21, 2011, and on the yearly anniversary of grant date until completely vested.

The weighted average grant-date fair value of all outstanding option grants was \$0.24 and \$0.10 per share, for the six months ended June 30, 2010 and 2009, respectively. We determine the fair value of share-based awards at their grant date, using a Black-Scholes Option-Pricing Model applying the assumptions in the following table.

|  | Six Months Ended June 30, |            |
|--|---------------------------|------------|
|  | 2010                      | 2009       |
| Expected life (years)                                | 2.9 - 3<br>years          | 3.41 years |
| Dividend yield                                       | 0.0%                      | 0.0%       |
| Expected volatility                                  | 93.6%                     | 67.3%      |
| Risk free interest rates                             | 1.5%                      | 1.3%       |
| Weighted average fair value of options at grant date | \$ 0.24                   | \$ 0.10    |

During the six months ended June 30, 2010, 112,507 shares of restricted stock vested and 16,407 shares of restricted stock were forfeited. The compensation committee granted 460,000 shares of common stock to the members of the Board of Directors, which were fully vested upon grant. Options to purchase 1,014,219 shares of common stock were exercised and the cash proceeds from the option exercises totaled approximately \$473,000.

### Warrants – Non-Employees

At June 30, 2010 and December 31, 2009 there were outstanding warrants to purchase approximately 1.0 million shares of common stock, which were either (i) issued in connection with the August 2006 financing, or (ii) issued to outside consultants. The exercise price of the warrants ranges from \$9.15 to \$12.00.

## 6. SIGNIFICANT CUSTOMERS

Approximately 99% and 95% of revenues for the three-month periods ended June 30, 2010 and 2009 are generated from either the U.S. Government or contractors to the U.S. Government. Approximately 100% and 98% of revenues for the six month periods ended June 30, 2010 and 2009 are generated from either the U.S. Government or contractors to the U.S. Government.

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APPLIED ENERGETICS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)

7. NET LOSS PER SHARE

Basic net income (loss) per common share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during 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 income (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 convertible preferred stock, stock options, warrants and restricted stock units. Contingently issuable shares are included in the computation of basic earnings (loss) per share when issuance of the shares is no longer contingent. Due to the losses from continuing operations for the six months ended June 30, 2010 and 2009, basic and diluted loss per common share were the same, as the effect of potentially dilutive securities would have been anti-dilutive.

Potentially dilutive securities not included in the diluted loss per share calculation, due to net losses from continuing operations, were as follows:

|                                       | Six Months Ended June 30, |           |
|---------------------------------------|---------------------------|-----------|
|                                       | 2010                      | 2009      |
| Options to purchase common shares     | 4,480,130                 | 2,517,832 |
| Warrants to purchase common shares    | 1,024,939                 | 1,091,605 |
| Unvested restricted stock units       | -                         | 180,841   |
| Convertible preferred stock           | 134,572                   | 135,572   |
| Total potentially dilutive securities | 5,639,641                 | 3,925,850 |

8. DIVIDENDS

As of June 30, 2010, we had 134,572 shares of our 6.5% Series A Convertible Preferred Stock outstanding. A dividend was declared and paid in common stock on August 1, 2010 to the holders of record as of July 15, 2010.

Dividends on Preferred Stock are accrued when the amount and kind of the dividend is determined and are payable quarterly on the first day of February, May, August and November, in cash or shares of common stock, at the discretion of the company.

On May 10, 2010, we exchanged 1,000 shares of Series A Preferred Stock for 10,000 shares of common stock. The company accounted for the transaction pursuant to Accounting Standards Codification (“ASC”) 470-20-25. The exchange was made at terms other than the original conversion terms, therefore the Company recorded a charge (stock dividend) to accumulated deficit of approximately \$11,000, which equaled the excess of the fair value of the common stock issued over the fair value of the common stock issuable pursuant to the original conversion terms. Furthermore, the historical carrying value of the Series A Preferred Stock exchanged was reclassified within paid-in capital at the time of conversion.

9. COMMITMENTS AND CONTINGENCIES

LITIGATION

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

We 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 we breached warranties we 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.

APPLIED ENERGETICS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)

We filed a petition in the Supreme Court of the State of New York, New York County to stay the arbitration on the ground that the claims are not subject to arbitration. NewOak removed the proceeding to the United States District Court, Southern District of New York, and filed a motion to compel arbitration.

We intend to defend ourselves vigorously in any arbitration or legal proceedings and believe we have substantial defenses to the claims.

In addition, we may from time to time be involved in legal proceedings arising from the normal course of business. As of the date of this report, we have not received notice of any other legal proceedings.

10. SUBSEQUENT EVENTS

We performed an evaluation of subsequent events and determined that no events required disclosure.

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

Our discussion and analysis of the financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the related disclosures included elsewhere herein and in Management's Discussion and Analysis of Financial Condition and Results of Operations included as part of our Annual Report on Form 10-K for the year ended December 31, 2009.

### CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the securities laws. 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", "would", "could", "should", "expect", "project", "anticipate", "estimates", "possible", "plan", "strategy", "target", "prospect" or "continue" and other similar terms and phrases. 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. Important factors that could cause our actual results to differ materially from our expectations are described in Item 1A. (Risk Factors) of our Annual Report on Form 10-K, as amended, for the year ended December 31, 2009 and Quarterly Report on Form 10-Q for the period ended March 31, 2010. 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.

### 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"<sup>TM</sup>), we have gained expertise and proprietary knowledge in high performance ultrashort pulse 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. We have developed an effective and robust counter-IED ("CIED") technology as a result of our research and development. Additionally, we develop and manufacture high-voltage and ultrashort pulse laser products for government and commercial customers for a range of applications.

During the second quarter of 2010, we continued to support our US Marine Corps ("USMC") customers' CIED requirements. This has involved supporting extended field operations overseas beyond the successful conclusion of the Operational Assessment at the request of the field commander, including the production of additional systems and spare parts, training of new operators and support of additional military units. We continue to work with the Marine Corps Systems Command on developing a smaller version of the technology for installation on other military platforms and vehicles, and upgrading the engineering documentation of the system. This work is being performed under the \$10.4 million contract modification received in January of 2010. Discussions with other large defense contractors in developing teaming arrangements to support the next generation of CIED systems are continuing. We expect that utilizing the resources and capabilities of established Department of Defense ("DoD") contractors will allow us to focus on the technology development within our core capabilities. Organizations we have identified have

experience and a sound track record in delivering fully qualified military systems and the associated documentation and certifications to DoD customers. We will continue to concentrate our efforts on maintaining our excellent customer relationships.

During the second quarter of 2010, we continued the development and advancement of our LGE technology by working with our customer, the U.S. Army's Research, Development and Engineering Command, who provided a \$1.8 million increase in funding in June to our existing Army contract. This brings the total contract value to \$4.9 million. In June, we delivered our ultrashort pulse laser system to the U.S. Navy, which involved factory acceptance testing, training of Government personnel on the system operation and maintenance, delivery, installation and final acceptance testing at NSWC Crane, IN. The delivery of the system has led to discussions concerning the next phase of this program, which may include the development of an ultrashort pulse laser suitable for installation on a test aircraft, and delivery of similar systems to other U.S. Government organizations.

## RESULTS OF OPERATIONS

## COMPARISON OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2010 AND 2009:

|                            | 2010         | 2009           |
|----------------------------|--------------|----------------|
| Revenue                    | \$ 2,879,932 | \$ 1,730,141   |
| Cost of revenue            | 2,794,693    | 1,631,316      |
| General and administrative | 525,354      | 2,825,062      |
| Selling and marketing      | 232,699      | 191,001        |
| Research and development   | 3,658        | 322,986        |
| Other (expense) income:    |              |                |
| Interest expense           | (1,667)      | -              |
| Interest income            | 2,110        | 16,807         |
| Net loss                   | \$ (676,029) | \$ (3,223,417) |

## REVENUE

Revenue increased approximately \$1.2 million to \$2.9 million for the three months ended June 30, 2010 compared to \$1.7 million for the three months ended June 30, 2009. Revenues from the CIED product line increased by \$1.4 million to \$2.1 million as work continues on the contract modification of \$10.4 million received in January 2010. Additional revenue of \$100,000 was derived from our new Ultrashort Pulse Laser product line. LGE product line revenues decreased by \$257,000 to \$667,000, and High Voltage product line revenues decreased by \$77,000 for the three months ended June 30, 2010 compared to the three months ended June 30, 2009.

## 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 increased approximately \$1.2 million to \$2.8 million for the three months ended June 30, 2010, compared to \$1.6 million for the three months ended June 30, 2009. The increase in cost of revenue is tied to the increase in sales revenue of 66%, and to provisions for losses on current contracts of approximately \$38,000, which are tied to the High Voltage and Laser product lines.

## GENERAL AND ADMINISTRATIVE

General and administrative expenses decreased approximately \$2.3 million to \$525,000 for the three months ended June 30, 2010 compared to \$2.8 million for the three months ended June 30, 2009. The change was the result of decreases in salaries and wages of approximately \$490,000 as a result of our staff reductions which took place in 2009; supplies and building related expenses of \$200,000 as a result of consolidating facilities, which reduced overall operational costs in 2010; depreciation and amortization expense of \$88,000; and non-cash compensation costs of approximately \$80,000. Applied labor, overhead and material handling costs allocated to cost of revenue increased by approximately \$224,000, reducing general and administrative expense. In addition, there was a reduction in professional services of approximately \$1.1 million from the settlement of the class action and derivative lawsuits that occurred in 2009 and asset disposals of \$93,000 for leasehold improvements made to the St. Louis facility in 2009.



## SELLING AND MARKETING

Selling and marketing expenses increased approximately \$42,000 to \$233,000 for the three months ended June 30, 2010 compared to \$191,000 for the three months ended June 30, 2009. The increase is mostly related to business development activities associated with the new Laser and High voltage product lines as we continue to focus on entering new markets for these products and grow our non-government market revenue.

## RESEARCH AND DEVELOPMENT

Internal research and development expenses decreased by approximately \$319,000 to \$4,000 during the three months ended June 30, 2010 as compared to \$323,000 for the three months ended June 30, 2009. Our internal research and development costs involve experimentation, design, development and enhancement of proprietary technologies and new products. The decrease in internal research and development expense is primarily due to the deployment of key technical personnel to fulfilling current contracts.

## INTEREST INCOME AND INTEREST EXPENSE

Net interest income for the three months ended June 30, 2010 was lower by approximately \$15,000 as compared to the three months ended June 30, 2009 primarily due to the lower balance of invested funds.

## NET LOSS

Our operations for the three months ended June 30, 2010 resulted in a net loss of approximately \$676,000, a reduction of approximately \$2.5 million compared to the \$3.2 million loss for the three months ended June 30, 2009.

## COMPARISON OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2010 AND 2009:

|                            | 2010           | 2009           |
|----------------------------|----------------|----------------|
| Revenue                    | \$ 6,474,709   | \$ 4,317,539   |
| Cost of revenue            | 6,163,369      | 4,032,763      |
| General and administrative | 1,602,586      | 5,260,785      |
| Selling and marketing      | 304,353        | 429,024        |
| Research and development   | 36,520         | 840,647        |
| Other (expense) income:    |                |                |
| Interest expense           | (3,334)        | (19)           |
| Interest income            | 4,572          | 47,834         |
| Net loss                   | \$ (1,630,881) | \$ (6,197,865) |

## REVENUE

Revenue increased approximately \$2.2 million to \$6.5 million for the six months ended June 30, 2010 compared to \$4.3 million for the six months ended June 30, 2009. Revenues from the CIED product line increased by \$2.8 million to \$4.3 million and the new Ultrashort Pulse Laser product line had revenues of approximately \$665,000 in the 2010 period. Offsetting these increases were the decreases in the LGE product line of approximately \$1.2 million and the High Voltage line of approximately \$78,000.

## 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 increased approximately \$2.2 million to \$6.2 million for the six months ended June 30, 2010, compared to \$4.0 million for the six months ended June 30, 2009. The increase in cost of revenue is tied to the increase in sales revenue of 50% and to provisions for losses on current contracts of approximately \$38,000; which are tied to the High Voltage and Laser product lines.

## GENERAL AND ADMINISTRATIVE

General and administrative expenses decreased approximately \$3.7 million to \$1.6 million for the six months ended June 30, 2010 compared to \$5.3 million for the six months ended June 30, 2009. The change was the result of decreases in salaries and wages of approximately \$1.3 million as a result of downsizing efforts which took place in 2009; non-cash compensation costs of approximately \$434,000; supplies and building related expenses of \$278,000 as a result of consolidation of facilities which reduced overall operations costs in 2010; depreciation and amortization expense of \$173,000, and travel expenses of approximately \$43,000. Applied labor, overhead and material handling costs allocated to cost of revenue increased by \$187,000 reducing general and administrative expense. In addition, there was a reduction in professional services of approximately \$1.1 million from the settlement of the class action and derivative lawsuits that occurred in 2009 and asset disposals of \$93,000 for leasehold improvements made to our former St. Louis facility in 2009.

## SELLING AND MARKETING

Selling and marketing expenses decreased approximately \$125,000 to \$304,000 for the six months ended June 30, 2010 compared to \$429,000 for the six months ended June 30, 2009. The decrease is mostly related to business development activities that occurred in the first quarter of 2009 associated with our former St. Louis facility. Additionally, we continue to invest in our new Laser and High Voltage product lines as we continue to focus on entering new markets for these products, thus to grow our non-government market share.

## RESEARCH AND DEVELOPMENT

Internal research and development expenses decreased by approximately \$804,000 to \$36,000 during the six months ended June 30, 2010 as compared to \$841,000 for the six months ended June 30, 2009. Our internal research and development costs involve experimentation, design, development and enhancement of proprietary technologies and new products. The decrease in internal research and development expense is primarily due to deployment of key technical personnel to fulfill current contracts.

## INTEREST INCOME AND INTEREST EXPENSE

Net interest income for the six months ended June 30, 2010 was lower by approximately \$43,000 as compared to the six months ended June 30, 2009 primarily due to the lower balance of invested funds.

## NET LOSS

Our operations for the six months ended June 30, 2010 resulted in a net loss of approximately \$1.6 million, a reduction of approximately \$4.6 million compared to the \$6.2 million loss for the six months ended June 30, 2009.

## LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2010, we had approximately \$8.9 million of cash and cash equivalents, and \$225,000 in a certificate of deposit. Our cash position increased by \$46,000 for the three months ended June 30, 2010, while the total cash decreased for the first six months of 2010 by approximately \$676,000. During the first six months of 2010, we used \$1.1 million of cash in operating activities, which was primarily comprised of our net loss of \$1.6 million, and increases in accounts receivables and other receivables of approximately \$886,000. Partially offsetting these amounts were non-cash compensation expense of \$658,000, an increase in accounts payable and accrued expenses of \$127,000, a decrease in prepaid expenses of \$302,000, and depreciation and amortization of approximately \$217,000. Additionally, investing activities used approximately \$2,000, and financing activities provided

approximately \$473,000 in proceeds from employee option exercises.

We anticipate that short-term and long-term funding needs will be provided by existing cash and cash equivalents and the cash flows 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. Government contracts, which currently 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 OF ORDERS

At June 30, 2010, we had a backlog (workload remaining on signed contracts) of approximately \$9.4 million, to be completed within the next twelve months.

## ITEM 4. CONTROLS AND PROCEDURES

### EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Our management, with the participation of our Principal Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2010. Based on that evaluation, our Principal Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

During the three months ended June 30, 2010, there was no significant change in our internal controls over financial reporting that has materially affected or which is reasonably likely to materially affect our internal controls over financial reporting.

## PART II – OTHER INFORMATION

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

## Issuer Purchases of Equity Securities

| Period       | (a)<br>Total<br>number<br>of<br>Shares (or<br>Units)<br>Surrendered | (b)<br>Average<br>Price Paid<br>per Share<br>(or Unit) | (c)<br>Total Number<br>of<br>Shares (or<br>Units)<br>Purchased as<br>Part of Publicly<br>Announced<br>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 |
|--------------|---|--|--|---|
| Mar.<br>2010 | 115,000   | \$ 0.60  | 115,000  | Undetermined  |

On May 10, 2010, we exchanged 1,000 shares of Series A Preferred Stock for 10,000 shares of common stock. The company accounted for the transaction pursuant to Accounting Standards Codification (“ASC”) 470-20-25. The exchange was made at terms other than the original conversion terms, therefore the Company recorded a charge (stock dividend) to accumulated deficit of approximately \$11,000, which equaled the excess of the fair value of the common stock issued over the fair value of the common stock issuable pursuant to the original conversion terms. Furthermore, the historical carrying value of the Series A Preferred Stock exchanged was reclassified within paid-in capital at the time of conversion.

## ITEM 5. OTHER INFORMATION

On July 27, 2010, the Compensation Committee of the Board of Directors determined to increase the base salary of Humberto Astorga, Chief Financial Officer of the corporation, from \$137,500 to \$150,000, effective August 2, 2010.

## ITEM 6. EXHIBITS

| EXHIBIT<br>NUMBER | DESCRIPTION  |
|-------------------|--|
| 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 Chief 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              | Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |

SIGNATURES

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

APPLIED ENERGETICS, INC.

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

Date: August 9, 2010

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