APPLIED ENERGETICS, INC.
Form 10-K
March 14, 2011

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

FORM 10-K

x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2010

¨ 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	77-0262908
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)

3590 East Columbia Street	
Tucson, Arizona	85714
(Address of Principal Executive Offices)	(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 x

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 x

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

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 x 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 x

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, 2010 (the last day of the registrant’s most recently completed second quarter) was approximately $86,947,000.

The number of outstanding shares of the registrant’s Common Stock, $.001 par value, as of March 10, 2011 was 91,071,778.

APPLIED ENERGETICS, INC.
ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2010
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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", "project", "anticipate", “estimates", "plans", "strategy", "target", "prospects" or "continue", and words of similar meaning. 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 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. 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”) was founded on the premise that 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 Improvised Explosive Device (“counter-IED” or “CIED”) technology as a result of the work done on LGE. As LGE and our counter-IED systems have matured, we have created unique expertise and competitive advantages in, USP lasers, solid state high voltage systems, and charged particle acceleration systems. 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.

LGE and LIPC® Technologies

Applied Energetics is a 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 precise targeting. 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.

During 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 2010 to our existing Army contract. This brings the total funded value to $4.9 million to date.

Counter-IED Technologies

Working with the USMC, 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. The first version of this technology completed an Operational Assessment in March 2010, and has been extended on overseas operations at the request of the Marine Corps Field Commander. We have provided overseas field support since May 2009. We have recently completed a newer version of the technology that is more compact and suitable for integration on a variety of other military platforms. We continue to work actively with our customers to seek to field these innovative CIED technologies, and to develop variations that will meet their current and future mission needs.

Our CIED revenue was derived from work being performed under the $10.4 million contract modification received in January 2010. The contract increase involved the continuation of further Operational Assessment of the technology, developing additional systems, providing training and field support for systems, developing a smaller version of the technology for installation on other vehicle platforms, and developing the technical data package for the newer version of the system.

In August 2010, we entered into a strategic teaming agreement with L-3 Interstate Electronics Corporation (“L-3 IEC”) to pursue additional CIED contracts. This agreement allows us to focus on technology development, the development of high voltage systems, systems integration and testing and field support for our customers. L-3 IEC provides expertise in electronics design and manufacturing, systems engineering, and configuration management. We believe that this agreement positions us well as we expand our CIED product line. During 2010, L-3 IEC, as our subcontractor, has provided field services and support, and assisted with technical documentation. Discussions with other large defense contractors in developing teaming arrangements to support other strategic pursuits 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 military systems with associated documentation and certifications to DoD customers. It is expected that Applied Energetics would maintain the position of prime contractor for these future production contracts, with the other organizations acting as subcontractors within their areas of expertise.

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 of scientists, engineers and technicians 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. We believe our electron beam technologies are more compact than competitive technologies and offer customers a capable solution for applications that require less space for implementation.

During 2010, we delivered a 300kV Electron Beam Gun system utilizing our Nested High Voltage Generator technology to a major chemical manufacturer. We continue to focus our efforts on this new technology and to developing the next generation of these products as we believe that there is potential growth in this market.

Laser Technologies

The company designs and builds solid state lasers for military and commercial applications. The company has the expertise to build uniquely capable, compact and rugged USP lasers and is in the process of developing laser systems for military and commercial customers. We believe our USP laser technology offers higher energy and average power than available from other companies which we believe will enable a range of industrial processing applications.

During 2010, we delivered our first USP laser system to our U.S. Navy customer in June, which is a significant achievement for this new business initiative. This demonstration system was designed to explore USP laser effects and determine requirements for potential deployment of USP lasers on a military aircraft.

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 build and protect the value of the intellectual property that we create, seeking to establish a preferred competitive position in the commercial marketplace. 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 twenty-nine U.S. patent applications are pending. We currently have U.S. Government initiated "national security related" secrecy orders for twelve of the twenty-nine 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 ten of these patent applications under secrecy order have been found patentable by the U.S. Patent Office. We have recently been notified that the secrecy orders related to two of our CIED patents has been rescinded. We expect that these patents will be publicly issued in the near future. Applied Energetics 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%, 97% and 87%, of total revenue for 2010, 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 could be developed to increase our business across new applications in the military, government and commercial sectors. The goals for the strategic plan included increasing revenues, achieving positive cash flow, profitability, development of new products and markets, diversifying our customer base and controlling costs to improve margins. In October 2010, we hired a Vice President of Business Development, whose office is based in the Washington, DC area to lead our business development efforts, to better serve our existing Government customers and to aggressively pursue new commercial and Government customers.

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 successfully 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, USP laser and HV technologies.

Our research and development expense for 2010, 2009 and 2008 was $161,280, $1,182,652, and $1,372,396, respectively. Our investment in internally funded research decreased during 2010 as we focused on delivering prototypes of our USP Lasers and Nested High Voltage Generators developed in the previous years. We expect our research and development efforts to be focused on advancing the technologies we have developed towards commercialization and developing innovative technologies that address and demonstrate emerging market needs.

Backlog of Orders

At December 31, 2010, 2009 and 2008, respectively, we had a backlog (i.e. work load remaining on signed contracts) of approximately $3.3 million, $3.4 million, and $4.6 million, respectively, to be completed within the twelve months following those dates. As of February 28, 2011, our backlog was approximately $1.4 million.

Employees

As of December 31, 2010, we had 54 full time employees, and 3 temporary employees. The breakdown of the employees is as follows: three in executive management, three in sales, marketing and business development, seven scientists, twenty-seven in technical and engineering, seven in manufacturing support and ten in administrative functions including accounting, human resources and information technology.

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 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.

The cash proceeds received from our 2005 and 2006 equity financings have satisfactorily funded our operating losses, our research and development program and the launch of our new products, working capital requirements, and strategic initiatives.

The development, enhancement and modification of technologies and products requires the commitment of substantial resources to conduct the time consuming research and development, field training and regulatory activities necessary to bring any potential technology or product to market and to establish production, marketing and sales capabilities. Our ability to fund our technologies and 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. In the event that our operating performance and cash and cash equivalents are not sufficient to satisfy our research and development efforts and working capital, we will be required to seek to raise additional equity or debt financings in order to sustain our current level of operations. We cannot assure you that any such financing will be available on affordable terms, or at all, if needed.

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

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 in 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. In addition, if the Government were to reduce our forces in Afghanistan or change the nature of the military's mission in Afghanistan, the urgent need for our CIED systems would be greatly reduced.

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 and commercialize 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;
- obtain commercial scale production orders from our Government and other customers;
- meet scheduled timetables and enter into suitable arrangements for the development, certification and delivery of new products;
- 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 and commercialize technologies and products, which will require the investment of 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 and commercialization of new technologies, products, and systems using our technologies. Due to the design complexity of our products, we may in the future experience delays in completing development and introduction on a commercial scale 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 technologies and 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 and commercialization 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.

We depend on Government customers for substantially all of our revenue and changes in government spending could significantly impact our sales and profitability.

Approximately 97%, 97% and 87%, of our net revenue for the years ended December 31, 2010, 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. 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. Competing demands for federal funds can put pressure on all areas of spending, which could impact the defense budget.

At the date of this report, Congress has not yet passed a baseline fiscal year 2011 defense budget, nor has it acted on the fiscal year 2012 defense budget submitted by the President. As a result, the Government is currently operating under a Continuing Resolution ("CR") that funds programs and services at fiscal year 2010 levels. The CR is set to expire on March 18, 2011, after which Congress will either pass a new appropriations bill or extend the CR. The latter case would likely fund programs at fiscal year 2010 levels, prevent the DoD from starting new programs, and would affect the contract funding of LIPC and LGE, and potentially delay new awards. Failure by Congress to pass a dedicated 2011 defense spending bill is expected to result in significant cuts to the government's research and development, and science and technology budgets to fund high priority projects, which could further jeopardize funding of our programs. We anticipate continued spirited debate over defense spending in 2011 as part of a larger dialog around the potential reductions in government spending. Budget decisions made in this environment could have immediate and long-term consequences for our company and the entire defense industry.

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.

A reduction in the quality of our relationship with the Government and defense agencies 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. The 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;
- 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;
- 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. During the year ended December 31, 2010, we derived approximately 69% of our revenues from supporting our USMC customer's CIED requirements. 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.

Our products may fail to perform satisfactorily in tests or field operations and even if our products perform satisfactorily, we may experience unanticipated delays in obtaining contracts, and may not obtain commercial scale production orders.

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 termination of the contract, or our inability to obtain commercial scale production orders, any of which could materially affect the development and manufacturing of such product and our prospects, revenue and financial condition.

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 further 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. 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.

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, 2010 was approximately $3.3 million. 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. 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. 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.

Our growth is subject to a number of economic risks.

Our business can 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 disruptions in financial markets and the adverse economic conditions that might occur and the effect such events might have on our business.

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;
- price erosion.

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

On December 14, 2010, 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. 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 ten 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.

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.

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 10, 2011, we had outstanding approximately 91 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 223,276 shares of common stock. There are also currently outstanding restricted stock, restricted stock units, options and warrants to purchase approximately 5.2 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.

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.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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.

Our aggregate rent expense, including common area maintenance costs, was approximately $123,000, $390,000 and $457,000 for 2010, 2009 and 2008, respectively.

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

See Note 12 to our 2010 Consolidated Financial Statements, which is incorporated herein by reference for information with respect to our lease commitments at December 31, 2010.

ITEM 3. LEGAL PROCEEDINGS

Except as described in Notes 12 to the Consolidated Financial Statements, which is incorporated herein by reference, as of December 31, 2010, 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

Performance Graph

Company/Market/Peer Group	12/31/2005	12/31/2006	12/31/2007	12/31/2008	12/31/2009	12/31/2010
Applied Energetics, Inc	$ 100.00	$ 40.55	$ 28.29	$ 3.17	$ 3.46	$ 8.42
NASDAQ Market Index	$ 100.00	$ 102.20	$ 112.97	$ 67.75	$ 98.46	$ 116.20
SIC Code Index	$ 100.00	$ 135.39	$ 177.99	$ 105.49	$ 125.10	$ 122.97

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, 2009 through December 31, 2010. No dividends on common stock were declared for these periods.

Quarterly Periods	High	Low
2009		
First	$ 0.43	$ 0.16
Second	0.69	0.22
Third	0.60	0.33
Fourth	0.54	0.25
2010		
First	0.85	0.33
Second	1.80	0.75
Third	1.44	0.98
Fourth	1.25	0.14

Holders of Record

As of March 10, 2011, there were approximately 633 holders of record of Applied Energetics' common stock.

Unregistered Sale of Securities and Use of Proceeds

There were no unregistered sales of securities in 2010.

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 paid dividends on our 6.5% Series A Convertible Preferred Stock in May, August and November 2010 and February 2011. In 2010, 1,000 shares of common stock were exchanged for 10,000 shares of preferred stock. Such exchange was determined to be an induced conversion and, as such required $11,500 to be reported as a special dividend. 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 2010, the company purchased 146,413 shares of common stock from the Board of Directors to satisfy withholding tax requirements or to satisfy payment of the option exercise price. Such purchases in the form of a net issuance occurred as follows:

Issuer Purchases of Equity Securities

Period	(a) Total number of Shares (or Units) Surrendered	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the

				Part of Publicly Announced Plans or Programs	Plans or Programs
Mar. 2010	115,000	$	0.60	115,000	Undetermined
Nov. 2010	14,368	$	0.87	14,368	Undetermined
Dec. 2010	17,045	$	0.88	17,045	Undetermined

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ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read in conjunction with the consolidated financial statements and the notes thereto contained herein in Item 8. "Financial Statements and Supplementary Data," and the information contained herein in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations." Historical results are not necessarily indicative of future results.

Following is a summary of Applied Energetics' selected financial data for the years ended and as of December 31, 2010, 2009, 2008, 2007, and 2006:

Consolidated Statements of Operations Data:

	Years Ended December 31,				
	2010	2009	2008	2007	2006
Revenue	$ 13,089,136	$ 7,459,808	$ 16,614,211	$ 12,403,628	$ 10,029,755
Net loss	$ (2,932,793)	$ (9,436,295)	$ (8,719,622)	$ (13,663,772)	$ (17,513,878)
Net loss attributable to common stockholders	$ (3,151,492)	$ (9,678,469)	$ (12,927,341)	$ (14,844,191)	$ (18,714,354)
Basic and diluted net loss per share attributable to common stockholders	$ (0.04)	$ (0.11)	$ (0.16)	$ (0.19)	$ (0.25)

Consolidated Balance Sheet Data:

	As of December 31,				
	2010	2009	2008	2007	2006
Total assets	$ 14,826,469	$ 15,261,376	$ 22,708,089	$ 29,466,870	$ 37,152,626
Total capital lease obligations	$ -	$ -	$ 2,028	$ 15,965	$ 77,510

Please refer to the Notes to the Financial Statements beginning on page F - 7 of this report for a more complete description of the numbers contained in the table above.

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, LGE, we have gained expertise and proprietary knowledge in high performance USP lasers, high-voltage electronics, advanced dynamic optics and atmospheric and plasma interactions. We apply these technologies to develop 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 technology as a result of our research and development. Additionally, we develop and manufacture high-voltage and USP laser products for government and commercial customers for a range of applications.

At the date of this report, Congress has not yet passed a baseline fiscal year 2011 defense budget, nor has it acted on the fiscal year 2012 defense budget submitted by the President. As a result, the Government is currently operating under a Continuing Resolution ("CR") that funds programs and services at fiscal year 2010 levels. The CR is set to expire on March 18, 2011, after which Congress will either pass a new appropriations bill or extend the CR. The latter case would likely fund programs at fiscal year 2010 levels, prevent the DoD from starting new programs, and would affect the contract funding of LIPC and LGE, and potentially delay new awards. Failure by Congress to pass a dedicated 2011 defense spending bill is expected to result in significant cuts to the government's research and development, and science and technology budgets to fund high priority projects, which could further jeopardize funding of our programs. We anticipate continued spirited debate over defense spending in 2011 as part of a larger dialog around the potential reductions in government spending. Budget decisions made in this environment could have immediate and long-term consequences for our company and the entire defense industry.

Counter-IED Technologies:

Working with the USMC, 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. The first version of this technology completed an Operational Assessment in March 2010, and has been extended on overseas operations at the request of the Marine Corps Field Commander. We have provided overseas field support since May 2009. We have recently completed a newer version of the technology that is more compact and suitable for integration on a variety of other military platforms. We continue to work actively with our customers to field these innovative CIED technologies, and to develop variations that will meet their current and future mission needs. 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. In addition, if the Government were to reduce our forces in Afghanistan or change the nature of the military's mission in Afghanistan, the urgent need for our CIED systems would be greatly reduced.

LGE 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. 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.

High-Voltage Technologies:

Since the company's inception, it has acquired and developed unique high-voltage capabilities. The company's capabilities include 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. We believe our electron beam technologies are more compact than competitive technologies, and offer customers a capable solution that requires less space for implementation.

Laser Technologies

The company designs and builds solid state lasers for military and commercial applications. The company has the expertise to build uniquely capable, compact and rugged USP lasers and is in the process of developing laser systems for commercial and military customers. Our USP laser technology offers higher energy and average power than available from other companies, which we believe will enable a range of industrial processing applications.

Emerging Markets and Applications

During 2010, we updated our strategic plan, which outlines the transition of Applied Energetics from a high technology start up company to a mature organization that produces long term growth and value to our customers and shareholders. Our key strategies involve leveraging our areas where we have created unique expertise and have competitive advantages. These include:

- USP Laser System military and commercial market development
- High Voltage and Pulsed Power System government and commercial market development
- Enabling innovation and establishing new core competencies
- Build on the success of our CIED technologies and system, which is an example of our ability to innovate, develop, field and support new technologies that meet critical customer needs
- Balance tactical and strategic activities to be successful in both the near term and the future.

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, 2011, 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. 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 and 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-Merton 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 a midpoint scenario, where the expected life is determined to be half of the time from grant to expiration, regardless of vesting, (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.

Recoverability of Property and Equipment

We assess recoverability of property and equipment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable.

We assess the recoverability of property and equipment 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.

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.

Results of Operations

Our consolidated financial information for the years ending December 31, 2010, 2009 and 2008 is as follows:

	2010	2009	2008
Revenue	$ 13,089,136	$ 7,459,808	$ 16,614,211
Cost of revenue	12,274,759	7,007,923	15,874,818
General and administrative	2,924,439	6,795,972	8,470,656
Settlement expenses	-	1,337,409	-
Selling and marketing	664,665	631,578	251,349
Research and development	161,280	1,182,652	1,372,396
Other (expense) income:			
Interest expense	(5,374)	(1,131)	(2,099)
Interest income	8,588	60,562	637,475
Other income	-	-	10
Loss before provision for income taxes	(2,932,793)	(9,436,295)	(8,719,622)
Provision (benefit) for income taxes	-	-	-
Net loss	$ (2,932,793)	$ (9,436,295)	$ (8,719,622)

Revenue

Revenue increased approximately $5.6 million to $13.0 million for the year ended December 31, 2010 compared to 2009. Our CIED revenue increased by $6.7 million to $9.1 million in 2010 as we continued to support our USMC customer in developing additional systems, providing training and field support for systems, developing and documenting a smaller version of the technology for installation on other vehicles and platforms. Approximately 69% of our revenues for the year ended December 31, 2010 were derived from supporting our USMC customer's CIED requirements. Our USP Laser revenue increased by $358,000 and our HV revenue increased by $120,000 for the year 2010 as we continued our pursuit of new opportunities in these markets. LGE revenues decreased by $1.5 million to $3.0 million in 2010, largely due to reduced and delayed funding from our customers.

Revenue decreased approximately $9.2 million to $7.5 million for the year ended December 31, 2009 compared to 2008. Our CIED 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 CIED systems compared to manufacturing of CIED 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 increased by $5.3 million for the year ended December 31, 2010 compared to 2009. The increase in cost of revenue is directly tied to the increase in sales activity, less loss provisions of approximately $84,000 relating to the High Voltage product line.

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, CIED 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.

General and Administrative

General and administrative expenses decreased approximately $3.9 million for the year ended December 31, 2010 compared to 2009. Salaries and wages decreased by approximately $1.3 million, non-cash compensation costs decreased by approximately $810,000, supplies and building related expenses decreased by approximately $405,000, depreciation expenses decreased by approximately $190,000, professional services decreased by approximately $168,000, and losses on disposal of assets reduced by approximately $155,00. Additionally, we had an increase in applied labor, overhead and material handling costs allocated to cost of revenue of approximately $1.1 million. The decreases in expenses were offset by legal expenses defending against the NewOak litigation which amounted to approximately $292,000, which is described below.

At December 31, 2010, there were approximately $8,000 of unrecognized compensation costs related to unvested restricted stock awards, and approximately $316,000 of unrecognized compensation costs related to unvested stock options, net of estimated forfeitures. The costs for unvested stock options are expected to be recognized on a weighted-average basis over approximately one year. The costs for restricted stock awards are expected to be recognized ratably over the period of performance, but no later than the expiration date of December 1, 2012.

General and administrative expenses decreased approximately $1.7 million for the year ended December 31, 2009 compared to 2008. The decrease in general and administrative 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.

Pending Litigation

On or about January 14, 2010, we received notice that NewOak Capital Markets LLC ("NewOak"), 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 our 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 us 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, tortuous 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 $50,000,000, plus punitive damages and attorney’s fees and costs.

We filed a petition in the Supreme Court 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.

United States Magistrate Judge Gabriel Gorenstein issued a Report and Recommendation dated October 5, 2010 that NewOak's motion to compel arbitration should be denied. NewOak filed an objection to the Magistrate Judge’s Report. By order dated December 3, 2010, United States District Judge Richard Berman overruled the Magistrate Judge’s Recommendation and granted NewOak’s motion to compel arbitration.

We then filed a notice of appeal to the United States Court of Appeals, Second Circuit of the District Court's order, and also filed a motion for a stay of the arbitration pending appeal. The Second Circuit has granted an interim stay of the arbitration pending its decision on the motion for a stay, and, on March 10, 2011, granted a stay of the order compelling arbitration pending the appeal. We have filed our appeal brief, and NewOak's responsive brief was filed March 4, 2011.

In the event NewOak continues to pursue its claim, we intend to defend ourselves vigorously in any legal proceeding, and believe we have substantial defenses to the claims.

No accrual for loss has been established in connection with this pending litigation until such time a loss is likely to occur and a reasonable estimate of the loss or range of loss can be made.

Settlement Expenses

Litigation settlement expenses for 2009 were approximately $1.3 million. This amount represents $1,119,105 for the market 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 settled on September 29, 2009. We valued the shares based on the closing price of the shares on October 9, 2009, the date the shares were issued. Additionally, we had legal expense of $143,072 not covered by insurance proceeds.

Also included in litigation settlement expenses are $50,000 in settlement of an arbitration demand filed by eScrub Systems Inc. and $25,233 in legal expenses incurred associated with this settlement.

Selling and Marketing

Selling and marketing expenses increased by approximately $33,000 for the year ended December 31, 2010 compared to 2009. The increase was mostly due to increases in labor allocation and of approximately $118,000 associated with increased business development and bids and proposals activities. The increases in labor expenses were offset by reduction in tradeshow participation and travel costs of approximately $84,000.

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, largely tied to LGE contracts.

Research and Development

Research and development expenses decreased approximately $1.0 million for the year ended December 31, 2010 compared to 2009. The decrease in internal research and development expense is primarily due to the deployment of technical personnel to fulfilling current contracts. During the second half of 2010, we initiated two key projects geared toward providing products from our USP Laser product line and to maturing our nested high voltage electron beam gun for commercialization. Our internal research and development costs involve experimentation, design, development and enhancement of proprietary technologies and new products.

Research and development expenses decreased approximately $190,000 for the year ended December 31, 2009 compared to 2008.

Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Net interest income for 2010 was lower by approximately $52,000 from 2009 primarily due to the lower balance of invested funds and to investments being held in cash and money markets.

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 2010 resulted in a net loss of approximately $2.9 million, a decrease of approximately $6.5 million compared to the approximately $9.4 million net loss for 2009. Our net loss attributable to common stockholders per common share – basic and diluted decreased from $0.11 per share to $0.04 per share, largely due to the reduction of net loss and to a slight increase in the number of shares outstanding in 2010.

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, 2010, we had approximately $9.0 million of cash and cash equivalents, a decrease of approximately $600,000. In 2010, we used approximately $1.4 million in operating activities. During 2010, we received approximately $12.2 million in cash from customers, and paid approximately $8.3 million to our suppliers. An additional $5.3 million was paid to, or on behalf of our employees. The net cash outflow from operating activities is approximately $1.4 million. Also in 2010, investing activities caused net cash inflow of approximately $158,000 and financing activities caused net cash inflow of approximately $623,000.

We anticipate that short-term and long-term funding needs will be provided from existing cash and cash equivalents, and by cash generated from operating activities. We believe that we have sufficient working capital to fulfill existing contracts, expected contracts, and strategic initiatives for 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. There can be no assurance, however, that we will continue to generate cash flows at or above current levels.

Backlog

At December 31, 2010, 2009 and 2008, respectively, we had a backlog (i.e. work load remaining on signed contracts) of approximately $3.3 million, $3.4 million, and $4.6 million, respectively, to be completed within the twelve months following those dates. As of February 28, 2011, our backlog was approximately $1.4 million.

Contractual Obligations:

The following table summarizes our contractual obligations and other commercial commitments as of December 31, 2010:

	Payment by Period				
	Total	Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
Operating leases	$ 99,462	$ 99,462	$ -	$ -	$ -
Purchase Obligations	639,480	639,480	-	-	-
Total	$ 738,942	$ 738,942	$ -	$ -	$ -

Included in the above table are obligations for which we are contractually liable, but are specific to cost type reimbursable government contracts. Not included in the above table are the dividends on our Series A Preferred Stock that are approximately $200,000 each year (approximately $50,000 each quarter), assuming no conversion of the outstanding shares of Series A Preferred Stock into shares of common stock.

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 $123,000, $390,000, and $457,000 for 2010, 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, 2010, there were 107,172 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.

Off-Balance Sheet Arrangements

As of December 31, 2010, we had no significant off-balance sheet arrangements other than operating leases. For a description of our operating leases, see Note 12 to the consolidated financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

In the normal course of business, our financial position is subject to a variety of risks, such as the ability to collect our accounts receivable and the recoverability of the carrying values of our long-term assets. We do not presently enter into any transactions involving derivative financial instruments for risk management or other purposes.

Our available cash balances are invested in money market funds (invested primarily in Government Securities) with generally immediate liquidity. These short-term cash-like investments are subject to general interest rate and general market risks. However, lack of timely access to these funds or loss of any portion of principal could be catastrophic to the ongoing funding and health of our business. Substantially all of our cash flows are derived from our operations within the United States and today we are not subject to market risk associated with changes in foreign exchange rates.

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' 2010 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

Not applicable.

ITEM 9A. 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, 2010. 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, 2010, 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, 2010.

The effectiveness of our internal control over financial reporting as of December 31, 2010 has been audited by BDO USA, LLP, an independent registered public accounting firm, as stated in their report, which is included below.

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, 2010 that materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Applied Energetics, Inc.

Tucson, Arizona

We have audited Applied Energetics, Inc.'s internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Applied Energetics, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, Applied Energetics, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Applied Energetics, Inc. as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2010 and our report dated March 14, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP
Phoenix, Arizona
March 14, 2011

ITEM 9B. OTHER INFORMATION

Not Applicable

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, Term expiring in
James M. Feigley	61	Chairman of the Board	2012
Joseph C. Hayden	52	President and principal executive officer	
Humberto A. Astorga	38	Controller, principal financial officer and principal accounting officer	
Eric F. Lau	46	Chief Operating Officer and Vice President of Engineering	
George P. Farley	72	Independent Director	2012
James K. Harlan	59	Independent Director	2013
John F. Levy	55	Independent Director	2011
Mark J. Lister	53	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 for Advanced Amphibious Assault 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 President since June 2010 and Principal Executive Officer since April 2009. Mr. Hayden also served as Chief Operating Officer. Previously, he served as Executive Vice President - Programs for Applied Energetics (since December 2004), directing all new business capture and the execution of awarded contracts. Prior to that, he was Executive Vice President of Business Operations from November 2002 to 2004. He is a founder of the company.

Formerly, Mr. Hayden was a Program Manager and Senior Principal Systems Engineer at Raytheon Missile Systems working in the Directed Energy Weapons and JSOW missile product lines. From 1998 to 1999, Mr. Hayden was the Engineering Manager for Delta V Technologies, Inc., overseeing the design and manufacture of high vacuum coating systems for the commercial thin film and glass coating industries. From 1993 to 1997, Mr. Hayden was employed by Molten Metal Technology, Inc., an environmental high technology start-up company. As Director of Commercial Services for Molten Metal Technology, he led the staffing and start-up of three hazardous waste processing plants, including a joint venture for radioactive waste processing in Oak Ridge, Tennessee. While Director of Research and Development Operations for Molten Metal Technology, he managed the operations at the company's R&D facility, which included a commercial-scale pilot plant. Mr. Hayden's career began in the United States Navy, where he served as a Nuclear Surface Warfare Officer. His billets included tours on nuclear powered aircraft carriers, guided missile cruisers and destroyers, including being a member of the pre-commissioning crew of the USS George Washington (CVN-73) where he was closely involved in the testing and acceptance of the ship's nuclear power plants. Mr. Hayden's additional Navy tours included being a staff member of the Atlantic Fleet, an instructor and company officer at the U.S. Naval Academy, and service at the Naval Electronics Systems Command. Mr. Hayden received a B.S. in Mechanical Engineering from the United States Naval Academy.

Humberto A. Astorga: Humberto A. Astorga has been our Chief Financial Officer since June, 2010, and 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.

Eric F. Lau: Eric F. Lau has been the Chief Operating Officer and Vice President of Engineering since December, 2010. Since July, 2009, Mr. Lau served as Director of Engineering and Operations. From December 2002 to July 2009, Mr. Lau was a Program Manager for the Laser Guided Energy (LGE) and Counter-IED (CIED) Programs. Prior to joining the company in December, 2002, Mr. Lau was the Vice President of Operations for Mission Viejo S. A. de C. V. from 1998 through 2002. From 1994 to 1998, Mr. Lau was the New Product Development Team Leader for P. L. Porter Company. From 1991 to 1994, Mr. Lau was a Senior Project Engineer at Robertshaw Controls, Co. and from 1986 to 1991, Mr. Lau was a Project and Design Engineer at ITT General Controls. Mr. Lau is a graduate of the University of Southern California, where he received a Bachelor's Degree in Mechanical Engineering.

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. Since 1999, Mr. Farley has operated a consulting practice in which he assists and advises public and private companies in complex financial transactions, on complex accounting and reporting issues and at time providing Chief Financial Officer services. 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 USA, LLP in 1962 and was a partner at BDO USA, 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 founded HNG Storage, an underground natural gas storage development and operations enterprise, in 1992, and served as Executive Vice President and Chief Financial Officer from 1998 to 2007. This company acquired, developed and operated several projects that were sold to major energy companies. From 1991 to 1997, Mr. Harlan served as Group Development Manager for the Pacific Resources Group based in Indonesia, which was engaged with various manufacturing and distribution businesses and joint ventures in Asia, Australia, and North America. Mr. Harlan has expertise in energy technology and markets having 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, serving on board audit and compensation committees from 2000 until 2008, when he became a candidate for U. S. Congress from Louisiana. Mr. Harlan is currently chief executive of the Vendevco group of companies with interests in oil/gas production, property and venture development in the United States and internationally. He also serves on the advisory committee for Washington University's International Center for Advanced and Renewable Energy and Sustainability.

John F. Levy: John F. Levy has been a director of the company since June, 2009. Mr. Levy serves as Chairman of our Nominating and Corporate Governance Committee and as a member of our Audit and Strategic Planning Committee. Since May 2005, Mr. Levy has served as the Chief Executive Officer of Board Advisory, 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 certified public accountant with nine years of experience with the national public accounting firms of Ernst & Young, Laventhol & Horwath and Grant Thornton. Mr. Levy is a director and non-executive Chairman of the Board of Applied Minerals, Inc., an exploration stage natural resource and mining company, a director, lead director and chair of the audit committee of Gilman Ciocia, Inc., a publicly traded financial planning and tax preparation firm, and a director of Brightpoint, Inc., a publicly traded company that provides supply chain solutions to leading stakeholders in the wireless industry. Mr. Levy was formerly a director of Take-Two Interactive Software, Inc. and PNG Ventures, Inc. Mr. Levy has authored The 21st Century Director: 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 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. Mr. Lister serves as the Chairman of our Strategic Planning Committee. 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 recently completed service on the Secretary of the Navy Advisory Panel and formerly served 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".
- 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 and audit committees 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.

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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.

Our Code of Ethics and Business Conduct is available at our website at www.appliedenergetics.com/default.aspx/investor-relations, or upon request made to us in writing at the following address, 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 (Chairman), 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 (Chairman) and Farley. 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. Levy (Chairman) 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

Executive Compensation Philosophy

Our board of directors is committed to establishing and maintaining executive compensation practices designed to support the development of the company’s capabilities and business objectives, enhance our profitability and enhance long-term shareholder value. Toward these aims, in March 2006, our board of directors established a compensation committee. This committee reports to the board on executive compensation matters.

Compensation Committee

Membership

The committee is currently comprised of two independent members of the Board. Director independence is, at a minimum, consistent with applicable rules for NASDAQ-traded issuers, Rule 16b-3 of the Exchange Act, and Section 162(m) of the Internal Revenue Code. Currently, the members of the committee are James K. Harlan (chairman), and George P. Farley. David C. Hurley, a former director, was also a member until the end of 2010, when he resigned the Board of Directors of the company.

Process and procedures for considering and determining executive and director compensation:

Among other things, the committee has the authority and responsibility under its charter to:

- Approve our compensation philosophy.
- Formulate, evaluate, and approve compensation for our officers, as defined in Section 16 of the Securities and Exchange Act of 1934 and rules and regulations promulgated therein.
- Formulate, approve, and administer cash incentives and deferred compensation plans for executives. Cash incentive plans are based on specific performance objectives defined in advance of approving and administering the plan.
- Oversee and approve all compensation programs involving the issuance of our stock and other equity securities.
- Review executive supplementary benefits, as well as our retirement, benefit, and special compensation programs involving significant cost to us, as necessary and appropriate.
- Oversee funding for all executive compensation programs.
- Review compensation practices and trends of other companies to assess the adequacy of our executive compensation programs and policies.
- Secure the services of external compensation consultants or other experts, as necessary and appropriate. These services, as required, will be paid from funds provided by the company. This system is designed to ensure the independence of such external advisors.
- Approve employment contracts, severance agreements, change in control provisions, and other compensatory arrangements with our executives.

Role of Principal Executive Officer in Recommending Executive Compensation.

The committee makes all compensation decisions related to our named executive officers. However, our Principal Executive Officer regularly provides information and recommendations to the committee on the performance of the executive officers, appropriate levels and components of compensation, including equity grants as well as other information as the committee may request.

Compensation Goals

Our compensation policies are intended to achieve the following objectives:

- reward executives and employees for their contributions to our growth and profitability, recognize individual initiative, leadership, achievement, and other valuable contributions to our company.

- to link a portion of the compensation of officers and employees with the achievement of our overall performance goals, to ensure alignment with the our strategic direction and values, and to ensure that individual performance is directed towards the achievement of our collective goals;
- to enhance alignment of individual performance and contribution with long-term stockholder value and business objectives by providing equity awards;
- to motivate and provide incentives to our named executive officers and employees to continually contribute superior job performance throughout the year; and
- to obtain and retain the services of skilled employees and executives so that they will continue to contribute to and be a part of our long-term success.

Compensation programs and policies are reviewed and approved annually but could be adjusted more frequently if determined by the committee. Included in this process is establishing the goals and objectives by which employee and executive compensation is determined. Executive officers' performance is evaluated in light of these performance goals and objectives. The committee consults the Principal Executive Officer on the performance of other company executives.

Compensation Surveys and Compensation Consultants

In determining compensation levels, we review compensation levels of companies that we deem to be similar to our company regardless of their location, competitive factors to enable us to attract executives from other companies, and compensation levels that we deem appropriate to retain and motivate our executives. From time to time, we retain the services of independent compensation consultants to review a wide variety of factors relevant to executive compensation, trends in executive compensation, and the identification of relevant peer companies. The committee makes all determinations regarding the engagement, fees, and services of our compensation consultants, and our compensation consultants report directly to our committee.

Elements of Compensation

Compensation for our executives is generally comprised of:

- base salary which is targeted at a competitive level and used to reward superior individual job performance of each named executive officer and to encourage continued superior job performance;
- cash bonuses which are tied to specific, quantifiable and objective performance measures based on a combination of corporate and individual goals;
- equity compensation which is based on corporate and individual performance, and discretionary equity awards;
- severance and change of control agreements;
- other benefits plan and programs.

The principles which serve as the basis for executive compensation practices apply to the compensation structures for all employees. Namely, corporate and individual performance are the key factors which determine incentive compensation.

The committee considers each component of executive compensation in light of total compensation. In considering adjustments to the total compensation of each named executive officer, the committee also considers the value of previous compensation, including outstanding equity grants and equity ownership.

Compensation paid to executive officers must be approved by our board of directors or by the committee. The committee conducts several meetings in person or telephonically to review and consider our compensation program and policies, as well as specific elements of executive compensation.

Compensation Considerations

In setting compensation levels for a particular executive, the committee takes into consideration:

- the proposed compensation package as a whole
- each element of compensation individually
- the executive's past and expected future contributions to our business
- our overall company performance,
- our financial condition and prospects,

- the need to retain key employees, and
- general economic conditions.

In order to enable the company to hire and retain talented executives, the committee may determine that it is in the best interests of the company to negotiate packages that may deviate from the company's standard practices in setting the compensation for certain of its executive officers when such deviation is required by competitive or other market forces.

Base Salary

Base salaries for the named executive officers and other executives are determined based on market data analysis of comparable positions in the identified compensation peer group. A competitive base salary is provided to each executive officer to recognize the skills and experience each individual brings to the company and the performance contributions they make. When determining the base salary for an executive, we refer to a target of the base salaries of similar positions in the identified compensation peer group. Other factors are also taken into account, such as internal comparisons, individual skills and experience, length of time with the company, performance contributions and competitiveness of the marketplace. Salaries are reviewed on an annual basis, taking into account the factors described above, and are made in connection with annual performance reviews. The amounts of such adjustments are calculated using merit increase guidelines based on the employee's position within the relevant compensation range and the results of his or her performance review. The recommended percentage increases are established annually and reflect the committee's assessment of appropriate salary adjustments based on competitive surveys and general economic conditions.

Other than the annual base salary for Principal Executive Officer, the levels of annual base salary were determined based on the recommendation made by the Principal Executive Officer and approved by the committee. Each individual’s educational qualifications, leadership skills, demonstrated knowledge and business accomplishments were also evaluated in determining base salary levels.

Base Equity Incentive

We provide basic equity grants as a retention incentive to our employees and managers in the form of stock options to support employees having an increasing equity stake and reward for the positive performance of the company. These equity awards serve as an important management tool to attract and retain key individuals for the company’s success. They also serve to provide each employee with a stake in the growth and success of the company. Normally these options are five year options that vest over three years in equal increments, which are priced as of the date of award, or the date of commencement of employment, with the first vesting increment occurring on the first anniversary of the award. The amount of basic equity grants options are awarded based upon the job classification of the employee, but may also reflect management assessments of an employee’s performance and contributions. Basic equity grant options are normally awarded at the following times:

- At time of hire.
- Upon promotion, assumption of greater responsibility, an advanced degree, or other appropriate milestone for an individual.
- Annually; based on management’s assessment of the individuals performance and on the individuals job classification.

Equity Bonus

Equity bonus grants will be made in the first quarter of the calendar year to reward the employees' achievement in the previous calendar year relative to his or her observable, measurable and quantifiable performance goals. The overall performance of the company will also be a consideration in order to encourage team effort.

The form of equity grants for performance has not been determined, and may vary from year to year between restricted stock, restricted stock units, or stock options.

On February 23, 2011, the Compensation Committee awarded, with a grant date of February 28, 2011, restricted stock units of 23,000, 17,000 and 17,000 to Joseph C. Hayden, Humberto A. Astorga and Eric F. Lau, respectively. The restricted stock units vest as to one-third of the shares on the third business day following the dates on which we file our Annual Report on Form 10-K for the years ending December 31, 2011, 2012 and 2013 with the Securities and Exchange Commission.

Cash Bonus

Our practice is to periodically consider awarding cash bonuses based upon, among other things, accomplishment of key objectives and overall performance. In addition, from time-to-time the committee may approve payment of bonuses to executives or key contributors for special accomplishment or other reasons. The compensation committee is currently determined to only award cash bonuses when the company has met certain cash flow objectives based upon earnings before interest, taxes depreciation and amortization expense. Generally, the company does not disclose specific targets relating to these goals, because doing so may disclose confidential business information. No cash bonuses were granted for 2010, and the compensation committee considers the possibility of a cash bonus in 2011 to be remote.

Severance and Change in Control Agreements

None of our named executives currently have such agreements.

Other Benefit Plans and Programs

Executives are eligible to participate in benefit programs designed for all of our full-time employees. These programs include a 401(K) savings plan and medical, dental, disability and life insurance programs. We currently cover the majority of such medical, dental and insurance payments, requiring a minor co-pay from the employee. Additionally, under our 401(K) plan employees are eligible to contribute to their 401(K) accounts through payroll deductions. In 2007, we implemented an employer match benefit where we matched 50% of the employees' 401(K) contribution up to 3% of their eligible compensation.

Summary Compensation Table

The following table discloses, for the periods presented, the compensation for the persons who served as our Principal Executive Officer, our Chief Financial Officer and our Chief Operating Officer for the years ended December 31, 2010, 2009 and 2008 (the "Named Executives").

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary (1)	Bonus (2)	Stock Awards	Option Awards (3)	All Other Compensation (4)	Total
Joseph C. Hayden	2010	$ 222,384	$ 25,000	$ -	$ -	$ 5,259	$ 252,643
President, principal	2009	$ 209,615	$ -	$ -	$ -	$ 4,479	$ 214,094
executive officer	2008	$ 225,000	$ -	$ -	$ -	$ 4,813	$ 229,813
Humberto A. Astorga	2010	$ 142,308	$ -	$ -	$ 16,432	$ 2,887	$ 161,627
Chief financial officer,	2009	$ 120,769	$ 22,750	$ -	$ 61,547	$ 1,650	$ 206,716
principal financial							
officer, Controller	2008	$ 112,500	$ 8,000	$ -	$ -	$ 3,488	$ 123,988
Eric F. Lau	2010	$ 140,414	$ -	$ -	$ 16,432	$ 4,063	$ 160,909
Chief Operating Officer,							
Vice President of							
Engineering							

(1) Mr. Hayden's 2010 salary reflects the increase of his base salary to $230,000 effective March 23, 2010 and his 2009 salary reflects the voluntary decrease of his base salary to $200,000 effective May11, 2009. Mr. Astorga's 2011 salary will reflect the increase of his base salary to $170,000 effective January 3, 2011. Mr. Astorga's 2010 salary reflects the increase of his base salary to $150,000 effective August 2, 2010. Mr. Astorga's 2009 salary reflects the increase of his base salary to $137,500 effective September 1, 2009 upon his appointment as Principal Financial officer from Controller of the company. Mr. Lau's 2010 salary reflects the increase of his base salary to $170,000 upon his appointment as Chief Operating Officer and Vice President of Engineering.

(2) Not included in the above table are amounts reflecting the value of Restricted Stock Units which vested in 2010, but were granted in prior years and an exercise of an option which was granted prior to 2010. Please see the table labeled "Option Exercises and Stock Vested" on page 37 for more detail.
(3) The amounts included in the "Option Awards" column represent the aggregate grant date fair value in 2010, 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 2010 Consolidated Financial Statements.
(4) The amounts shown in the "All Other Compensation" column are attributable to the company match expense for 401(k) contributions. All named executives received an employer matching benefit pursuant to which 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.

Grants of Plan-Based Awards

The following table discloses the grants of a plan-based award to each of the Named Executives in 2010:

Name	Grant Date	Estimated Future Payouts Under Equity Incentive Plan Awards Threshold (#)	Target (#)	Maximum (#)	All Other Stock Awards: Number of Shares of Stock (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($/Sh)	Grant Date Fair Value of Stock Awards (1)
Joseph C. Hayden		-	-	-	-	-	$ -	$ -
Humberto A. Astorga	3/23/2010(2)	-	50,000	50,000	-	50,000	$ 0.60	$ 16,432
Eric F. Lau	3/23/2010(2)	-	50,000	50,000		50,000	$ 0.60	$ 16,432

(1) The amounts included in the "Grant Date Fair Value of Stock Awards" column represent the full grant date fair value of the awards computed in accordance with ASC 718. The fair value of stock option awards is recognized in the income statement as non-cash, equity based compensation expense over the vesting period of the grants. For a discussion of valuation assumptions, see Note 8 to the Consolidated Financial Statements of our 2010 Financial Statements.
(2) Represents stock option awards granted to the named executive officers. These awards have an exercise price equal to the closing price of our common stock on the grant date and provide value to the recipient only if the price of our common stock increases after the grant date. There were no other performance or other market condition requirements included in the terms of the option awards to the named executive officers.

Employment Agreements for Named Executive Officers

We currently have no employment agreements for named executive officers.

Outstanding Equity Awards at Fiscal Year-End

The following table discloses unexercised options held by the Named Executives at December 31, 2010:

	Option Awards						Stock Awards		
Name	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
	-		-				-		$ -
Humberto A. Astorga	58,000	(1)	-		$ 0.50	03/09/2012	-		$ -
	83,333	(2)	83,334	(2)	$ 0.40	07/16/2014	-		$ -
	16,667	(3)	33,333	(3)	$ 0.60	03/23/2015	-		$ -
Eric F. Lau	-		-				3,375	(4)	$ 2,869
	69,500	(5)	-		$				
Joseph C. Hayden									