

APPLIED ENERGETICS, INC.  
Form 10-K  
March 13, 2008

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

**FORM 10-K**

- Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the fiscal year ended December 31, 2007
- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission File Number 001-14015**

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

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**77-0262908**  
(IRS Employer Identification Number)

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

**85714**  
(Zip Code)

**Registrant's telephone number, including area code (520) 628-7415**

<b>Securities registered pursuant to Section 12(b) of the Exchange Act:</b>	
<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
<b>Common Stock, \$.001 par value</b>	<b>The NASDAQ Stock Market LLC (Nasdaq Global Market)</b>

**Securities registered pursuant to Section 12(g) of the Exchange Act:**  
**Series A Preferred Stock, \$.001 par value**

\_\_\_\_\_  
(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 o 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 o 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 o

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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 definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, computed by reference to the last reported sales price at which the stock was sold on June 30, 2007 (the last day of the registrant's most recently completed second quarter) was approximately \$170,612,000.

The number of outstanding shares of the registrant's Common Stock, \$.001 par value, as of March 7, 2008 was 80,312,459.

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**APPLIED ENERGETICS, INC.**  
**ANNUAL REPORT ON FORM 10-K**  
**FOR THE YEAR ENDED DECEMBER 31, 2007**  
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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 securities laws. Forward-looking statements include all statements that do not relate solely to the historical or current facts, and can be identified by the use of forward looking words such as "may", "believe", "will", "expect", "expected", "project", "anticipate", "anticipated estimates", "plans", "strategy", "target", "prospects" or "continue". These forward looking statements are based on the current plans and expectations of our management and are subject to a number of uncertainties and risks that could significantly affect our current plans and expectations, as well as future results of operations and financial condition and may cause our actual results, performances or achievements to be materially different from any future results, performances or achievements expressed or implied by such forward-looking statements. This Form 10-K contains important information as to risk factors under Item 1A. In making these forward-looking statements, we claim the protection of the safe-harbor for forward-looking statements contained in the Private Securities Reform Act of 1995. Although we believe that the expectations reflected in such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to have been correct. We do not assume any obligation to update these forward-looking statements to reflect actual results, changes in assumptions, or changes in other factors affecting such forward-looking statements.

#### AVAILABLE INFORMATION:

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

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

#### GENERAL:

Applied Energetics, Inc. ("Applied Energetics," "we," "us," or the "company") is a developer and manufacturer of applied energy systems, primarily for military applications, utilizing our proprietary knowledge of high performance lasers, high voltage electronics, advanced adaptive optics and atmospheric and plasma energy interactions. Applied Energetics applies these technologies to deliver innovative solutions to urgent military missions, including neutralizing improvised explosive devices ("IEDs"), neutralizing vehicle-borne IEDs (i.e. car bombs), and non-lethal methods for vehicle stopping, among other high priority missions of U.S. and allied military forces. The targets, effects, ranges, voltages and currents delivered, along with many other aspects of our technologies are highly sensitive to ongoing military operations and are largely classified under specific Department of Defense ("DoD") guidelines and, consequently, cannot be disclosed publicly. We market our products and services directly to the U.S. military and to other allied customers. We are supported in this effort by a qualified Government Relations firm based in Washington DC. Additionally, Applied Energetics develops and manufactures high voltage and laser products for government and commercial customers for a range of applications. In February 2008, we changed our name to Applied Energetics, Inc.

#### LGE and LIPC Technologies:

Applied Energetics is the sole and exclusive developer of laser guided energy (“LGE<sup>™</sup>”) and laser induced plasma channel (“LIPC<sup>™</sup>”) technologies. These revolutionary technologies can precisely transmit high voltage electrical charges by using a laser to create a conductive path in the atmosphere. We are seeking to develop applications that can deliver tailored weapon and countermeasure effects to targets with laser accuracy, and with manageable affects and/or lethality to reduce the potential for inadvertent injury and 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 is currently funded through multiple 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.

Applied Energetics engages in research and development, prototype system integration, engineering design and equipment fabrication, field support and business development activities. Applied Energetics has entered into several contracts with its customers for products and services as well as for research on LGE and LIPC-based directed energy weapons, counter-IED systems, high voltage electronics, lasers, and technology development. Beginning In 2005, the company contracted for, designed and delivered counter-IED prototypes for U.S. military customers and to support those systems for testing and in-theatre operations. We are currently involved in a follow-on counter-IED program funded by the Joint IED Defeat Organization (“JIEDDO”) in support of a U.S. Marine Corps urgent need request, and we are pursuing opportunities to manufacture and support in the future additional systems and derivatives to this program for other U.S. and allied military forces and non-government security customers.

Our LGE technology delivers high voltage discharge waveforms (“electrical charge”) to a target through the atmosphere with laser beam accuracy. The electrical charge delivered can be tuned to result in a range of effects from temporary disruption to destruction of targets, based on the engagement situation and a weapon system with less-than-lethal to lethal effectivity which we believe will be well suited to robust deployment of a variety of applications on a range of military platforms. Our base technologies have been funded primarily using internal research and development resources while the advancement of these base technologies has accelerated using Government contract funding. Our business strategy is to pursue emerging and urgent military and security applications for LGE and related technologies while executing longer term development toward multi-mission / multi-platform fielding of LGE, and ultimately toward establishing Applied Energetics as the prime integrator of LGE-based platforms.

LGE effects have been demonstrated against a number of materiel, IED and personnel targets, in both laboratory and field tests. The results of these tests are sensitive in nature and controlled by our U.S. Government customer. Among other contracts, we currently have a contract to extend the available range of the system. In 2008, we expect to enter into additional contracts for LGE development, including improvement of existing products, the development of hardware technologies suitable for unique applications; additional target effects testing; and the development of system and operational technologies for specific urgent missions. To achieve our objectives, utilizing contract and internal research and development funds, we have developed additional laser sources, advanced high voltage systems, special-purpose optical systems, expanded target effects testing, furthered our understanding of the underlying physics of our systems and products and entered into teaming agreements with other defense contractors regarding cooperative development and marketing of our LIPC and LGE technologies and products.

U.S. Government support for our LGE and LIPC technologies continues through Congressional funding and military service line item funding in to the U.S. Navy budget, as well as funding that is transferred to the Navy from other services. We were awarded a \$9.8 million dollar contract by the Navy in April 2007. In August 2007, the Army Research Development and Engineering Center granted a \$2.1 million contract for a technology development program for ANVILS (Advanced Neutralization Vehicle-borne IEDs Integrated Laser System), for the application of directed energy technologies to counter the threat of vehicle-borne IEDs. The U.S. Army has approved a Research Development Testing and Evaluation budget line item for further LIPC/LGE development in fiscal year 2008. We are working with our Army customer to define the scope of effort and terms and we anticipate a contract with the Army in the first half of 2008.

In September 2007, we received a 24 month Phase II contract award from the Army Research Office for further development of a Light Filament Sensor, which is a follow on activity resulting from the success of the Phase I effort conducted in the latter half of 2006 and early 2007. That contract consists of a base contract of \$390,000 for the first 12 months, with a customer option for the second 12 months for another \$351,000. We are currently working on Phase II of this contract. This contract is the first in what we believe will be a series of new funded technology initiatives advancing the ultra-short pulse laser technology in support of LIPC/LGE for use in other military and commercial applications.

To get to longer distances with LGE, we recently delivered a transportable laser system to the Navy. This vehicle is a mobile laser laboratory which incorporates a terawatt class ultra-short pulse laser that can be used to conduct experiments and measurements of atmospheric interactions of very high peak power lasers at long ranges and in different weather conditions. We and our customer are already retrieving data from its operation.

Early embodiments of a LGE system may be modular self-contained units with narrow mission objectives, and may be temporarily installed on multi-purpose platforms such as medium trucks. In the longer term, we envision LGE system technology as an all-electric weapon, integrated with platform optical and electro-optical sensors and subsystems and other combat information systems, to form a primary multi-functional platform weapon system. We believe that our ability to develop such weapon systems, with the critical intersection of passive optics, laser, and high voltage in the LGE output system provides the unique opportunity for Applied Energetics to eventually establish itself as the prime, if not exclusive, weapon system integrator for LGE products.



### **Counter-IED Technologies:**

At the request of our U.S. Government customers, we developed major components, complete solutions, and integrated systems that demonstrate significant capability in countering IEDs, a major threat to military and security operations throughout the world. We completed numerous U.S. Government-sponsored tests of several prototype counter-IED systems. Technical and field results of such counter-IED testing are highly sensitive or classified, but we are satisfied that the full range of these tests accurately reflect the capability of our technology in addressing this critical mission. We have integrated our counter-IED technologies into various military and non-military vehicles, including remotely operated vehicles. Because of continued company-initiated innovations, we anticipate additional product variations may be utilized on other military platforms in the future as military customers identify new candidate areas for implementation of our technologies. We continue to work actively with our customers to field our counter-IED technologies.

In January and February of 2007, a version of our counter-IED technology was tested in response to a U.S. Marine Corps ("USMC") urgent need statement. As a result of this testing, the USMC requested and received funding from JIEDDO for development and testing of a variant of our counter-IED technology. In September 2007, Applied Energetics received a \$1.0 million contract from JIEDDO through the Naval Surface Warfare Center for engineering development and verification testing of newly adapted and packaged systems. The verification testing of this newer system occurred in October and November of 2007 and field testing of additional units by the USMC continues. We expect this activity to result in additional production and fielding of multiple units. We also expect that successful deployment of this system will create opportunities for follow-on engineering development and production of similar and derivative systems for other U.S. and allied military forces.

Our progress in development of our LGE and counter-IED technologies has resulted in significant interest by our customers. In particular, our DoD customers have identified certain urgent counter-IED applications for directed energy, including LGE, which, we believe, will lead to the development and fielding of mission-specific LGE platforms in the foreseeable future. We anticipate, although there can be no assurance, that we will receive contracts in the future for development of vehicle stopping and counter-Vehicle Borne IED systems. As counter-IED initiatives continue to be advanced by our customer, we intend to develop manufacturing capabilities to field the near-term proximity-related direct-discharge products and longer-term laser-guided versions of our products, as well as, other related proprietary technologies. We expect that some manufacturing activities may be undertaken through agreements with strategic partners.

### **High Voltage Technologies:**

Applied Energetics is participating in the long-term development of an innovative and proprietary technology in partnership with a major aerospace / defense contractor under an exclusive supplier agreement. This potentially important customer has made significant investments in concert with our own investments to advance this technology. The agreement provides for concept development, prototype fabrication and testing, and fabrication and delivery of operational hardware systems. We expect a series of follow-on orders as this technology is matured and readied for use. This agreement covers three years with options to extend for seven more years and includes provisions allowing Applied Energetics to pursue non-conflicting applications for the technology including our developed hardware and designs. This agreement limits the range of our public disclosure on details regarding the parties, technologies, and applications. We have deferred recognizing revenue until the initial contract phase is concluded and accepted by the customer. We estimate that our costs to complete the work on received purchase orders will exceed customer funding by approximately \$1.3 million and have recognized the effect of these estimates with a loss provision accrual to cost of revenue. However, we believe that development and investment is an important step in advancing our technologies into the commercial sector.

Since the company's inception it has acquired and developed unique high-voltage capabilities. Operating within the company is a group focused on providing high-voltage solutions for semiconductor, aerospace, environmental, and other commercial ventures and activities. North Star Power Engineering is a trade name under which we develop and market high-voltage opportunities.

**Military Laser Group:**

During 2007, the company assembled a military laser group with offices near St. Louis, Missouri. This group works in conjunction with the Tucson group and is comprised of an experienced team of engineers and technicians who collectively have built rugged lasers for many military and commercial customers. This group has successfully designed, built, and delivered high performance laser solutions which operate today in many unique and demanding environments. The company expects that this group will contribute to both revenue and earnings in 2008.

We continue to work with all customers to advance our operating performance and to improve the understandings of our emerging technologies. Our executive office is located at 3590 East Columbia Street, Tucson, Arizona 85714 and its telephone number is (520) 628-7415.

**PATENTS/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 establish barriers to competition. 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 reduce the likelihood of competitive solicitations. Presently, five patents have been issued and 30 patent applications are pending. We have received Government initiated “national security related” secrecy orders for 17 of the 30 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 two of these patent applications under secrecy order have been found patentable by the U.S. Patent Office. These patents and patent applications relate to our core LIPC technology, counter-IED offerings, and other technologies related to LGE, laser and high voltage applications.

**CUSTOMER DEPENDENCY AND ELECTION OF GOVERNMENT:**

Our revenue is derived from contracts with Government agencies or contractors to the Government which represents approximately 98%, 96%, and 96% of total revenue for 2007, 2006, and 2005, 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.

**COMPETITION:**

Substantially all of our activity is generated through contracts with agencies of the Government focused on military and national security applications. We have developed and demonstrated a LGE technology that is unique. We have also developed and produced counter-IED products using novel directed energy technologies. We believe that we are the only company in the United States that is providing the Government access to these currently 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 also be developing technologies that may compete with our technologies.

**RESEARCH AND DEVELOPMENT:**

We funded our original research and development through investment by our founders and investors and we retain the sole ownership of all of the original intellectual property. We believe the core intellectual property we have developed and control is necessarily central and critical to the use of the LIPC technology. We occasionally outsource research tasks to experienced individuals or companies for activities that require equipment or modeling capabilities that we do not have internally available. We have over ten relationships of this kind which provide that intellectual property developed under these agreements is the sole property of Applied Energetics.

Our short-term research and development goals are to develop efficient and compact laser sources, novel high voltage electrical sources, efficient optical systems extend the range of our LGE system and engineer the LGE hardware to

smaller and more rugged technologies. Longer term research objectives include development of tunable and eyesafe laser sources, adjunct military applications for lasers, and integrated weapon and counter-weapon system technologies.

Our research and development expense for 2007, 2006, and 2005 was \$1,197,792, \$3,571,262, and \$1,266,382, respectively.

#### **BACKLOG OF ORDERS**

At December 31, 2007, we had a backlog (that is, work load remaining on signed contracts) of approximately \$6.7 million to be completed within the next twelve months.

**EMPLOYEES:**

As of February 22, 2008, we had 79 employees, compared to 83 on December 31, 2006 and 103 on December 31, 2005. At February 22, 2008, 26 of our employees are in management and general administrative, 37 are in technical and engineering and 16 are in manufacturing.

**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**

**We have a history of losses and may not be able to achieve and maintain profitable operations.**

We have incurred net losses to our common stockholders since our formation in June 2002, including net losses attributable to common stockholders of \$14,844,191, \$18,714,354, and \$3,840,539 for the years ended December 31, 2007, 2006, and 2005, respectively. Additionally, losses are continuing to date. Our ability to achieve profitable operations is dependent upon, among other things, our ability to obtain sufficient Government and commercial contracts and to complete the development of products based on our technologies. We cannot assure you that we will be able to significantly increase our revenue or achieve and maintain profitability.

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

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

**The timing and magnitude of Government funding and orders for our Counter-IED system products cannot be predicted.**

We expect that we will be dependent upon sales of our Counter-IED system products for a substantial portion of our revenue over near future. In September 2007, we received a \$1.0 million contract from JIEDDO through the Naval Surface Warfare Center for engineering development and verification testing of newly adapted and packaged counter-IED systems. The verification testing of these newer systems occurred during the Fall of 2007 and early 2008. While we believe that the results of these tests and evaluations were favorable and will result in the production of multiple units for operational evaluation by the Marine Corps and eventual production and fielding, the Government's course of action will not be fully known until orders for product are issued to us. Because Government agencies have been identified as the intended customers for our counter-IED products, it is uncertain whether we will enter into such production orders and, if we do, what the timing or magnitude of such orders will be.

**We may not be able to meet the production demands for our Counter-IED system products, if we receive production orders.**

We intend to outsource certain manufacturing processes if our customers order a significant number of our Counter-IED products. We are uncertain that we will be able to find sufficient outsource facilities to meet the customer's demands for our Counter-IED products on a timely basis or at all.

**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 certain aspects of LIPC development through funding provided in the federal Government budget and contracts with various Government agencies. Due to federal budgetary constraints and an anticipated overall reduction in the defense budget, 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. We expect that additional funding for LIPC will be subject to our technology meeting certain Government established milestones. If our LIPC technology does not meet Government established milestones, additional Government funding may be reduced or eliminated. If additional Government funding for LIPC is reduced or is not forthcoming, in the absence of additional funding, our LIPC technology development efforts and revenues will be adversely affected.

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

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

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

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

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

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

Approximately 98%, 96% and 96% of our net revenue for the years ended December 31, 2007, 2006, and 2005, respectively, were to the U.S. Government and Government contractors. Therefore, any significant disruption or deterioration of our relationship with the Government or important agencies thereof could significantly reduce our revenue. Our Government programs must compete with programs managed by other defense contractors for a limited number of programs and for uncertain levels of funding. The development of our business will depend upon the continued willingness of the U.S. Government agencies to fund existing and new defense programs and, in particular, to continue to purchase our products and services. Although defense spending in the United States has increased in recent years, further increases may not continue and any proposed budget or supplemental budget request may not be approved. In addition, the U.S. Department of Defense may not continue to focus its spending on technologies or missions relevant to our technologies and products.

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



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

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

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

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

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

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

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

- procurement integrity;
- export control;

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

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

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

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

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

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

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

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

**Our products may fail to perform satisfactorily in tests at various stages of development and even if our products perform satisfactorily, there may be unanticipated delays in obtaining contracts.**

Our Government customers typically test our products at various stages of development. Although we believe our technologies will perform their ultimately intended applications, many of our products have not been completed to date. 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 could result in delay of product development, cost overruns or even termination of the contract, any of which could materially affect the development of such product and our prospects, revenue and final condition.

In the past, we have experienced delays in obtaining Government contracts despite what we have been advised by prospective Government customers after our products have been satisfactorily field tested. These delays are inherent in doing business with Government contracting agencies. Nevertheless, these delays make it difficult for us to predict and prepare for production and can adversely affect anticipated operating results.

**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 contract manufacturers 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 and 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 contract manufacturers 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.

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 and clean 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, disrupt and/or delay production and affect product reliability.

**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, we could suffer serious reputational 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, 2007 was approximately \$6.7 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 revenue.

**We depend on the recruitment and retention of qualified personnel, and our 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 personnel and executive officers. Our prospects depend upon our ability to attract and retain qualified engineering, manufacturing, marketing, sales and management 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, substantially all 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 targets, effects, ranges, voltages and currents delivered, along with many other aspects of our technologies are highly sensitive to ongoing military operations and are largely classified under specific Department of Defense guidelines and, consequently, cannot be

disclosed publicly. Accordingly, investors may not have important information concerning our businesses and operations with which to make an informed investment decision.

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

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

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

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

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

**We may face claims of infringement of proprietary rights.**

There is a risk that a third party may claim our products infringe on their proprietary rights. Whether or not our products infringe on proprietary rights of third parties, infringement or invalidity claims may be asserted or prosecuted against us and we could incur significant expense in defending them. If any claims or actions are asserted against us, we may be required to modify our products or obtain licenses on commercially reasonable terms, 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, substantial capital and operating costs to comply with these laws and regulations. In addition, new laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination or the imposition of new clean-up requirements could require us to incur costs in the future that would have a negative effect on our financial condition or results of operations.

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

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

- the size and timing of contract receipt and funding; changes in Government policies and Government budgetary policies;
- termination or expiration of a key Government contract;

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



**Our management and directors hold a significant portion of our outstanding voting stock and have control over stockholder matters.**

As of March 7, 2008, our management and directors owned approximately 17% of our outstanding common stock. Accordingly, they can exert significant influence over matters, which require stockholder vote, including the election of directors, amendments to our certificate of incorporation or approval of the dissolution, merger, or sale of our company, our subsidiaries or substantially all of our assets. This concentration of ownership and control by management and directors could delay or prevent a change in our control or other action, even when a change in control or other action might be in the best interests of other stockholders.

**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 7, 2008, we had outstanding approximately 80.3 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 two years 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 approximately 1.4 million shares of common stock. There are also currently outstanding restricted stock, restricted stock units, options and warrants to purchase approximately 7.1 million shares of our common stock. To the extent any of our options or warrants are exercised or the Series A Preferred Stock are converted, your percentage ownership 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(k). As the underlying shares are sold, the market price could drop significantly if the holders of these restricted shares sell them or if the market perceives that the holders intend to sell these shares.

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

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

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

Our Certificate of Incorporation authorizes our board of directors to issue up to 1,000,000 shares of "blank check" preferred stock without stockholder approval, in one or more series and to fix the dividend rights, terms, conversion rights, voting rights, redemption rights and terms, liquidation preferences, and any other rights, preferences, privileges, and restrictions applicable to each new series of preferred stock. In addition, our Certificate of Incorporation divides our board of directors into three classes, serving staggered three-year terms. At least two annual meetings, instead of one, will be required to effect a change in a majority of our board of directors. We also have a rights agreement, commonly known as a "poison pill" in place which provides that in the event an individual or entity becomes a beneficial holder of 12% or more of the shares of our capital stock, without the approval of the board of directors, our other stockholders shall have the right to purchase shares of our (or in some cases the acquirer's) common stock from us at 50% of its then market value. The designation of preferred stock in the future, the classification of our board of directors, its three classes and the rights agreement could make it difficult for third parties to gain control of our company, prevent or substantially delay a change in control, discourage bids for our common stock at a premium, or otherwise adversely affect the market price of our common stock.

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

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

**Our investment in securities available for sale are subject to risks, including risks relating to liquidity due to the recent failed auctions for auction rate securities which could result in a substantial impairment of our investments and significant losses.**

At December 31, 2007, we had \$7.5 million of government sponsored and government secured student-loan based investments. These securities have auction rate characteristics. The Dutch auction process resets the applicable interest rates at prescribed calendar intervals and is intended to provide liquidity to the holders of auction rate securities by matching buyers and sellers in a market context, enabling the holders to gain immediate liquidity by selling such securities at par, or rolling over their investment. If there is an imbalance between buyers and sellers, there is a risk of a failed auction. Subsequent to December 31, 2007, auctions relating to those types of auction rate securities we hold failed. Further, over the past few months, there had been an unprecedented number of auctions failures for other types of auction rate securities. An auction failure is not a default. As of December 31, 2007, our investments were carried at par value as we believe that the investments approximated full value based upon comparable and similar successful auctions for similar student-loan backed investments that occurred in December 2007, January 2008 and February 2008. Due to the current illiquidity in the market, we have reclassified these investments to long-term assets. We do not currently intend to liquidate these investments at below par value or prior to a reset date. However, systemic failure of future auction rate securities particularly for auctions of securities similar to those held by us may result in an extended period of illiquidity and may lead to a substantial impairment of our investments or the realization of significant future losses at the point of liquidation. We will assess the fair value of these securities at the end of each quarter to determine whether an impairment charge may be required. As market conditions continue to evolve we may take an impairment charge in the future, which may be meaningful.

**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.

On September 16, 2005 we took possession of approximately 7,000 square feet of additional manufacturing space in Tucson. The monthly rent for this property is approximately \$5,100, escalating to \$5,311 per month effective July 2008, under a lease that expires June 30, 2009.

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

In June 2006, we commenced a 3-year non-cancellable, renewable operating lease for approximately 11,000 square feet, in Tucson, at a monthly rent of approximately \$5,300 with annually-set monthly rent escalations of up to \$5,600. We are also responsible for certain property related costs, including insurance, utilities and property taxes.

In June 2007, we commenced a 3-year non-cancellable, renewable operating lease for approximately 11,000 square feet, in Earth City, MO, at a monthly rent of approximately \$6,000. We are also responsible for certain property related costs, including insurance, utilities and property taxes.

Rent expense was approximately \$910,000, \$906,000, and \$733,000 for 2007, 2006, and 2005, respectively.

See Note 12 to the Consolidated Financial Statements of our 2007 Financial Statements, which is incorporated herein by reference for information with respect to our lease commitments at December 31, 2007.

**ITEM 3. LEGAL PROCEEDINGS:**

See Note 12 to the Consolidated Financial Statements of our 2007 Financial Statements, which is incorporated herein by reference for information with respect to our lease commitments at December 31, 2007.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS:**

Not Applicable.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASE OF EQUITY SECURITIES:****Market price per share**

Our common stock is currently listed on the NASDAQ Global Market, trading under the symbol "AERG." The following table sets forth information as to the price range of our common stock for the period January 1, 2006 through December 31, 2007. No dividends on common stock were declared for these periods.

	High	Low
<u>Quarterly Periods</u>		
2006		
First	\$ 14.10	\$ 9.60
Second	14.82	4.90
Third	8.62	4.52
Fourth	4.92	3.64
2007		
First	6.25	4.10
Second	6.57	3.78
Third	4.36	2.65
Fourth	4.19	2.85

**Holders of Record**

As of March 7, 2008, there were approximately 238 holders of record of Applied Energetics' common stock.

**Dividends**

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

Dividends on our Preferred Stock are payable quarterly on the first day of February, May, August and November, in cash or shares of Common Stock, at our discretion. We declared and paid dividends on our 6.5% Series A Convertible Preferred Stock in May, August and November, 2007 and February, 2008. All of these dividends were paid in the form of common stock. Dividends on Preferred Stock are accrued when the amount of the dividend is determined. The recording of these dividends had no effect on our cash or total balance sheet equity.

**Equity Compensation Plan Information**

See Item 12.

**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, 2007, 2006, 2005, 2004, and 2003.

**Consolidated Statements of Operations Data:**

	Years Ended December 31				
	2007	2006	2005	2004	2003
Revenue	\$ 12,403,628	\$ 10,029,755	\$ 18,875,928	\$ 10,930,522	\$ 383,273
Net loss	\$ (13,663,772)	\$ (17,513,878)	\$ (3,624,603)	\$ (3,261,005)	\$ (3,242,109)
Net loss attributable to common stockholders	\$ (14,844,191)	\$ (18,714,354)	\$ (3,840,539)	\$ (3,261,005)	\$ (3,242,109)
Basic and diluted net loss per share attributed to common stockholders	\$ (0.19)				