APPLIED ENERGETICS, INC.
Form 10-K
April 14, 2014

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, 2013

¨ **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)

4585 South Palo Verde Road, Suite 405	
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	**Over the Counter Bulletin Board**

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 x No ¨

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

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

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

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 28, 2013 (the last day of the registrant's most recently completed second quarter) was approximately $1,720,000.

The number of outstanding shares of the registrant's Common Stock, $.001 par value, as of March 18, 2014 was 91,735,662.

APPLIED ENERGETICS, INC.

ANNUAL REPORT ON FORM 10-K

FOR THE YEAR ENDED DECEMBER 31, 2013

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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. 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") designs, develops and manufactures solid sta
Ultra Short Pulse ("USP") lasers for commercial applications and applied energy systems for commercial and military applications. Through our technology development efforts, we have gained expertise and proprietary knowledge in high performance lasers and high-voltage electronics.

Applied Energetics, Inc. is a corporation organized and existing under the laws of the State of Delaware. Our executive office is located at 4585 South Palo Verde Road, Suite 405, Tucson, Arizona, 85714 and our telephone number is (520) 628-7415.

Recent Developments

The U.S. Government has significantly reduced defense spending over the past few years and we do not anticipate receiving any meaningful additional Government funding in the near future. We have completed all of our Government contracts and do not have any funded Government contracts for future work. We have also developed our USP laser technologies and systems for commercial markets. We have not generated meaningful sales of our commercial systems and we have one existing agreement for the lease of our High Voltage equipment. We are not investing company funds or resources to further develop and enhance our technologies and systems or market our systems other than the submission of proposals for Government contracts. As of March 18, 2014, our backlog was approximately $ -0-.

As a result of the decrease in U.S. Government funding, we have significantly reduced our workforce to a level consistent with our expected operations.

Since we are unable to determine if we will be able to obtain any meaningful contracts or generate meaningful revenue or profitable operations in our current line of business, we are considering strategic alternatives, including mergers, the acquisition of one or more businesses or technologies, and/or the disposition of one or more of our existing businesses. Absent the award of a significant new Government contract, we do not expect to continue our current businesses for any meaningful period of time and our continuation as a going concern is dependent upon the success of our strategic efforts.

High-Voltage Technologies

We have acquired and developed unique high-voltage capabilities 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.

Defense

We have delivered innovative technologies and systems to address urgent military requirements, including neutralizing improvised explosive devices and other high priority missions of U.S. military forces.

LGE and LIPC® Technologies

Upon our inception in 2002, we began developing LGE and LIPC technologies intended to precisely deliver high voltage electrical charges by using a laser to create a conductive path in the atmosphere. We have protected 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.

We have completed all funded work authorized under our contract with the U. S. Army’s Research, Development and Engineering Command (“ARDEC”). We continue to respond to ARDEC requests for proposal on additional funding for development of our LGE technology; however, there is no assurance that further funding will be awarded.

Counter-IED Technologies

We have developed and delivered a system that demonstrated significant capability in over 200 missions in Afghanistan countering IEDs from mid-2009 through early 2011.

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. Presently, eighteen U.S. Patents have been issued and twenty-five U.S. patent applications are pending. We currently have U.S. Government initiated “national security related” secrecy orders for eleven of the twenty-five 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 eleven of these patent applications under secrecy order have been found patentable by the U.S. Patent Office. Applied Energetics 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

Historically, revenue was derived from contracts with Government agencies or contractors to the Government representing approximately 61% and 90% of total revenue for both 2013, and 2012, respectively. The significant reduction in Government funding for our LGE, LIPC and counter-IED technologies and systems has had, and will continue to have, a material adverse effect on Applied Energetics. We do not anticipate receiving any meaningful funding from our Government Customers in 2014 and thus continued operations will be dependent on funding from new customers yet to be developed. When we refer to “Government” we mean the U.S. Government and its agencies. Over the past three years our efforts have increasingly focused on developing and attempting to market applications of our technologies for commercial products and markets. We believe that both our USP laser technologies and the compact high voltage generation systems offer unique capabilities that surpass performance for competitive commercial products in the marketplace of which we are aware.

Competition

Within the USP laser and commercial high voltage markets there exists established companies which offer competitive products in our market segment. These competitors have substantial existing customer bases throughout the various worldwide markets.

Historically, substantially all of our activity and revenue was 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. 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 have historically funded our research and development primarily through internal investment and we diligently attempt to retain the sole ownership of all of the key intellectual property.

Our research and development expense was approximately $-0- and $157,000 for 2013 and 2012, respectively. Our investment in internally funded research further decreased during 2013 as we completed the building of prototypes in late 2011 and early 2012 for our USP lasers and nested high voltage generators. We expect our research and development efforts to remain at a reduced level as we do not intend to invest our own funds on further development and advancement of our LGE, LIPC, counter-IED and high voltage technologies.

Backlog of Orders

At December 31, 2013 and 2012, respectively, we had a backlog (i.e., work load remaining on signed contracts) of approximately $25,000 and $26,000, respectively, to be completed within the twelve months following those dates. As of March 18, 2014, our backlog was approximately $-0-.

Employees

As of December 31, 2013, we had 1 full time employee and 3 part-time employees. The breakdown of the employees is as follows: One in executive management, one in manufacturing support and two in administrative functions including accounting and human resources. As of March 18, 2014, we had 1 full-time employee and 3 part-time employees.

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:

- requiring us to cease operations and/or change the nature of our business;
- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our flexibility in planning for, or reacting to, opportunities in our business and our industry;
- restricting us from exploiting business opportunities;
- 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.

We are exploring strategic alternatives which may change the nature of our business.

Because of the lack of government funding have received, we have significantly reduced our work force and are seeking strategic alternatives. As a result, we may acquire one or more businesses or technologies which may or may not be related to our existing businesses and may dispose of one or more existing businesses. As a result, the nature of our business may change and such change may occur without stockholder approval.

Our independent auditors have expressed substantial doubt about our ability to continue as a going concern, which may hinder our ability to obtain future financing.

In their report accompanying our financial statements, our independent auditors stated that our financial statements for the year ended December 31, 2013 were prepared assuming that we would continue as a going concern, and that they have substantial doubt as to our ability to continue as a going concern. Our auditors have noted that our recurring losses from operations and negative cash flow from operations and the concern that we may incur additional losses due to the reduction in Government contract activity raise substantial doubt about our ability to continue as a going concern.

We do not intend to invest our own funds to further develop and enhance LGE, LIPC, or counter-IED technologies and systems and do not anticipate receiving Government funding in the near terms.

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

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. We do not expect to invest our own funds to further develop and advance those technologies and systems.

Lack of government funding and uncertainty of future levels of defense spending has inhibited and will continue to inhibit our ability to obtain future funding from Government sources or from public capital sources consistent with our prior history. We do not expect that it is likely that we will receive additional Government funding for our LGE, LIPC, or counter-IED technologies and subsystems in the near term. As a result our revenues can be expected further decline and losses will continue for the foreseeable future.

The timing and magnitude of Government funding and orders for our technologies and systems cannot be predicted.

We do not have any funded Government contracts. 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, the reduction in US forces in Afghanistan has really reduced the urgent need for our counter-IED system.

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.

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, LGE and counter-IED technologies and systems. If additional Government funding for LIPC, LGE and counter-IED is reduced or is not forthcoming, in the absence of additional funding, our future technology development efforts would 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; and
- enter into suitable arrangements for volume production of mature products.

We believe that, in order to be 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. However, we do not intend to invest our funds in the further development. 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.

The long sales cycles for our products may cause us to incur significant expense without offsetting revenues.

Our potential customers are likely to view the purchase of our products as a significant and strategic decision. As a result, we expect them to expend significant effort in evaluation, testing and qualifying our products before making a decision to purchase them, resulting in a lengthy initial sales cycle. While our customers are evaluating our products and before they place an order with us, we may incur substantial sales and marketing and research and development expenses to customize our products to the customers' needs. We may also expend significant management efforts, increase manufacturing capacity and order long lead-time components or materials prior to receiving an order. Even after this evaluation, a potential customer may not purchase our products. As a result, these long sales cycles may cause us to incur significant expenses without ever receiving revenue to offset such expense.

Our commercial laser systems are complex in design and may contain defects that are not detected until installed and operated by our customers, which could increase our costs and reduce our revenues.

Laser systems are inherently complex in design and require ongoing regular maintenance. The manufacture of our lasers involves a highly complex and precise process. As a result of the technological complexity of our products, changes in our or our suppliers' manufacturing processes or the inadvertent use of defective materials by us or our suppliers could result in a material adverse effect on our ability to achieve acceptable manufacturing yields and product reliability. To the extent that we do not achieve and maintain our projected yields or product reliability, our business operating results, financial condition and customer relationships would be adversely affected.

Our customers may discover defects in our products after the products have been fully installed and operated under the end user's peak stress conditions. In addition, some of our products are combined with products from other vendors, which may contain defects. As a result, should problems occur, it may be difficult to identify the source of the problem. If we are unable to identify and fix defects or other problems, we could experience, among other things:

- loss of customers;
- increased costs of product returns and warranty expenses;
- damage to our brand reputation;
- failure to attract new customers or achieve market acceptance;
- diversion of development and engineering resources; and
- legal actions, including for personal injury and property damage, by our customers and/or their end users.

The occurrence of any one or more of the foregoing factors could seriously harm our business, financial condition and results of operations.

The commercial markets for our laser products are unpredictable and characterized by rapid technological changes and evolving standards demanding a significant investment in research and development, and, if we fail to address changing market conditions, our business and operating results will be harmed.

The photonics industry is characterized by extensive research and development, rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Because this industry is subject to rapid change, it is difficult to predict its potential size or future growth rate. Our success in generating revenues in this industry will depend on, among other things:

- building our relationships with our customers;

- the education of potential end-user customers about the benefits of lasers and laser systems; and
- our ability to accurately predict, and develop our products to meet, industry standards.

We cannot assure you that our expenditures for research and development will result in the introduction of new products or, if such products are introduced, that those products will achieve sufficient market acceptance or to generate sales to offset the costs of development. Our failure to address rapid technological changes in our markets could adversely affect our business and results of operations.

We continuously evaluate the commercial viability of each of our technologies and, if we determine that the commercial viability of a technology is not justified by the investment needed to generate meaningful revenues, we may determine to discontinue such efforts.

We have historically depended on Government customers for substantially all of our revenue and changes in government spending have significantly impacted our sales and profitability.

Approximately 61% and 90% of our revenue for the years ended December 31, 2013 and 2012, respectively, were from the U.S. Government and Government contractors. The recent trend for the U.S. defense spending has been decreasing, and is expected to be in a downward trend for the foreseeable future. We do not expect to receive Government funding for our LGE, LIPC, and counter-IED systems in the near term and expect our revenues to further decline and losses to continue for the foreseeable future.

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 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. The shift in Government defense spending to other programs in which we are not involved and a reduction in Government defense spending generally has had and will continue to have severe consequences for our results of operations.

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. 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. 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.

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 competitors 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 do. 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 have historically derived a substantial portion of our revenue from a limited number of contracts. Therefore, our revenue will continue to be adversely affected if we fail to receive new contracts and renewals or follow-on contracts.

During the year ended December 31, 2013, we derived approximately 61% of our revenues from our U.S. Air Force contract to develop a compact, high power, pulse generator to be used as a High Power Microwave (HPM) power supply. The loss of Government funding has adversely affected our revenue and, as a result, we anticipate revenue may continue to decline and losses to continue for at least the foreseeable future.

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 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.

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. To the extent we obtain Government contracts or significant commercial contract 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 has historically involved 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 to date were 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.

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

Our operating results have varied 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 continue to fluctuate as a result of considerations that are difficult to forecast, such as:

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

We are subject to the penny stock rules adopted by the Securities and Exchange Commission that require brokers to provide extensive disclosure to their customers prior to executing trades in penny stocks. These disclosure requirements may cause a reduction in the trading activity of our common stock, which in all likelihood would make it difficult for our stockholders to sell their securities.

Rule 3a51-1 of the Securities Exchange Act of 1934 establishes the definition of a “penny stock,” for purposes relevant to us, as any equity security that has a minimum bid price of less than $5.00 per share or with an exercise price of less than $5.00 per share, subject to a limited number of exceptions which are not available to us. This classification would severely and adversely affect any market liquidity for our common stock.

For any transaction involving a penny stock, unless exempt, the penny stock rules require that a broker or dealer approve a person’s account for transactions in penny stocks and the broker or dealer receive from the investor a written agreement to the transaction setting forth the identity and quantity of the penny stock to be purchased. In order to approve a person’s account for transactions in penny stocks, the broker or dealer must obtain financial information and investment experience and objectives of the person and make a reasonable determination that the transactions in penny stocks are suitable for that person and that that person has sufficient knowledge and experience in financial matters to be capable of evaluating the risks of transactions in penny stocks.

The broker or dealer must also deliver, prior to any transaction in a penny stock, a disclosure schedule prepared by the SEC relating to the penny stock market, which, in highlight form, sets forth:

- The basis on which the broker or dealer made the suitability determination; and
- That the broker or dealer received a signed, written agreement from the investor prior to the transaction

Disclosure also has to be made about the risks of investing in penny stocks in both public offerings and in secondary trading and commission payable to both the broker-dealer and the registered representative, current quotations for the securities and the rights and remedies available to an investor in cases of fraud in penny stock transactions. Finally, monthly statements have to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks.

Because of these regulations, broker-dealers may not wish to engage in the above-referenced necessary paperwork and disclosures and/or may encounter difficulties in their attempt to sell shares of our common stock, which may affect the ability of selling stockholders or other holders to sell their shares in any secondary market and have the effect of reducing the level of trading activity in any secondary market. These additional sales practice and disclosure requirements could impede the sale of our common stock, if and when our common stock becomes publicly traded. In addition, the liquidity for our common stock may decrease, with a corresponding decrease in the price of our common stock. Our common stock, in all probability, will be subject to such penny stock rules for the foreseeable future and our stockholders will, in all likelihood, find it difficult to sell their shares of common stock.

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

As of March 18, 2014, we had outstanding approximately 92 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

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 2,000,000 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. Moreover, the holders of our outstanding Series A Preferred Stock have a right to put their shares to the Company for $2.7 million in the event of a change of control. Such right could hinder our ability to sell our assets or merge with another company.

The redemption and dividend provisions of our outstanding preferred stock are onerous due to our current financial condition.

As of December 31, 2013, the liquidation preference of our outstanding preferred stock was approximately $2.7 million which represents approximately 214% of our total assets. If an event occurs that would require us to redeem the preferred stock, we may not have the required cash to do so.

In addition, our annual dividend payment on the preferred stock is approximately $268,000, which will further deplete our cash or significantly dilute our common stockholders of we pay the dividend in shares of common stock. We have not made the last three quarterly payments in 2013 and, as a result, the dividend rate has increased to 10% per annum and will remain at that level until such failure no longer continues. Dividends in arrears as of February 28, 2014 were $201,000. These terms may also make it more difficult for us to sell equity securities or complete an acquisition.

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.

The commercial products and systems that we sell are considered capital equipment and the company's financial condition may preclude future sales due to perceived risk for service and warranties.

Both our commercial laser systems and compact high voltage equipment are expected to be major capital equipment purchases for industrial manufacturing. Companies evaluate these systems based upon a number of factors and criteria which include the ability of suppliers to provide long-term warranty, maintenance, technical and parts support. The company's present financial condition may be viewed as an impediment to providing long-term customer service for these major capital equipment purchases.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

In 2013, we entered into month-to-month agreements to lease approximately 6,000 square feet of office, manufacturing and storage space in Tucson, Arizona.

Our aggregate rent expense, including common area maintenance costs, was approximately $48,000 and $23,000 for 2013 and 2012, respectively.

We believe our facilities are adequate for our currently expected level of operations.

See Note **9** to our 2013 Consolidated Financial Statements, which is incorporated herein by reference for information with respect to our lease commitments at December 31, 2013.

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

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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 quoted for trading on the Over the Counter Bulletin Boards and the OTC Markets, trading under the symbol "AERG.OB". The following table sets forth information as to the price range of our common stock for the period January 1, 2012 through February 26, 2014. No dividends on common stock were declared for these periods.

Quarterly Periods	High	Low
2012		
First	0.12	0.06
Second	0.08	0.04
Third	0.06	0.03
Fourth	0.05	0.02
2013		
First	0.05	0.02
Second	0.05	0.02
Third	0.03	0.01
Fourth	0.02	0.01
2014 (Thru March 31, 2014)		
First	0.05	0.01

Holders of Record

As of March 18, 2014, there were approximately 403 holders of record of Applied Energetics' common stock.

Unregistered Sale of Securities and Use of Proceeds

There were no unregistered sales of securities in 2013.

Dividends

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. We paid dividends via the issuance shares of Common Stock on our 6.5% Series A Convertible Preferred Stock in 2011. We paid cash dividends on our 6.5% Series A Convertible Preferred Stock in 2012 and February and May 2013. The company's Board of Directors did not declare the dividends due August 1, November 1, 2013 and February 1, 2014. Accordingly, the company did not pay these dividends. Dividend arrearages as of December 31, 2013 and February 28, 2014 were $134,000, and $201,000, respectively.

Equity Compensation Plan Information

See Item 12.

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, Inc. ("company", "Applied Energetics", "we", "our" or "us") designs, develops and manufactures solid sta Ultra Short Pulse (USP") lasers for commercial applications and applied energy systems for military applications. Through our technology development efforts, we have gained expertise and proprietary knowledge in high performance lasers and high-voltage electronics. We have suspended the majority of our Government work due to the lack of Government funding.

High-Voltage Technologies

We have acquired and developed unique high-voltage capabilities 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.

LGE and LIPC® Technologies

Upon our inception in 2002, we began developing LGE and LIPC technologies intended to precisely deliver high voltage electrical charges by using a laser to create a conductive path in the atmosphere. 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.

We have completed all contracted work authorized under our contract with the U. S. Army's Research, Development and Engineering Command ("ARDEC"). We continue to respond to ARDEC requests for proposal on contracts for development of our LGE technology; however, there is no assurance that a contract will be awarded.

Counter-IED Technologies

We have developed and delivered a system that demonstrated significant capability in over 200 missions in Afghanistan countering IEDs from mid-2009 through early 2011.

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, 2013, 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 on our common stock, (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, 2013, and 2012 is as follows:

	2013	2012
Revenue	$42,686	$1,335,421
Cost of revenue	35,852	1,148,906
General and administrative	1,391,590	2,757,510
Selling and marketing	37,511	776,054
Research and development	-	157,313
Other (expense) income:		
Interest expense	-	(1,651)
Interest income	4,847	2,536
Loss before provision for income taxes	(1,417,420)	(3,503,477)
Provision (benefit) for income taxes	-	-
Net loss	$(1,417,420)	$(3,503,477)

Revenue

Revenue decreased by approximately $1.3 million to $43,000 for the year ended December 31, 2013 compared to $1.3 million for the year ended December 31, 2012. Revenue from the LGE product line decreased by $629,000 to $4,000 and High Voltage revenue decreased by $665,000 to $39,000 for the year ended December 31, 2013 compared to the year ended December 31, 2012. There was no revenue from Laser or the C-IED product line for the year ended December 31, 2013. We have completed all work under our Government contracts and do not have any funded Government contracts for future work due to the lack of Government funding and are not investing company funds or resources to develop or enhance our technologies or systems. Although we continue to make proposals for Government contracts we do not anticipate receiving additional Government funding in the near future and expect our revenue to remain at these reduced levels because of the significant reduction in U.S. Government spending. We currently have one agreement for the lease of our High Voltage equipment.

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 decreased by $1.1 million for the year ended December 31, 2013 compared to 2012. The decrease in cost of revenue is directly tied to the decrease in sales activity of approximately 97%. Cost of revenue as a percentage of revenue improved to 84% from 86% last year.

General and Administrative

General and administrative expenses decreased approximately $1.4 million to $1.4 million for the year ended December 31, 2013 compared to $2.8 million for the year ended December 31, 2012. Salaries, wages and benefits decreased by approximately $1.2 million, which is reflective of our reduction in workforce; miscellaneous expense decreased by $609,000 which reflects the $720,000 loss on the sale of our building and land in 2012, partially offset by gains on the sales of fixed assets; professional services decreased by approximately $409,000; depreciation and amortization decreased by $152,000, reflecting the sale of our building and the sale of other depreciable assets as we downsized to a smaller facility; insurance and insurance & miscellaneous fees decreased by $141,000; supplies and building related expenses decreased by approximately $140,000; non-cash compensation costs decreased by approximately $46,000; cost of temporary help decreased by $25,000; and travel related expenses decreased by $22,000. Offsetting these reductions in operating expenses totaling approximately $2.7 million was a decrease in absorption of labor and overheads of approximately $1.4 million previously charged to Government contracts. Cost saving measures were initiated in 2011 and have continued, in response to the decrease in revenue and lack of Government contracts, including reductions of our workforce and reductions in other operating expenses.

At December 31, 2013, there were approximately $2,000 of unrecognized compensation costs related to unvested restricted stock awards. The costs for restricted stock awards are expected to be recognized on a weighted-average basis over approximately 0.21of a year.

Selling and Marketing

Selling and marketing expenses decreased by approximately $739,000 for the year ended December 31, 2013 compared to 2012. The decrease was mostly due to the reduction of workforce as well as the cessation of our bid and proposal activity in 2013.

Research and Development

Research and development expenses decreased approximately $157,000 for the year ended December 31, 2013 compared to 2012. Our investment in internally funded research ceased during 2012 as we completed the building of prototypes at the end of 2011 and early 2012.

Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Net interest income for 2013 was higher by approximately $4,000 from 2012 primarily due to interest income on our bank deposits.

Net Loss

Our operations in 2013 resulted in a net loss of approximately $1.4 million, a decrease of approximately $2.1 million compared to the approximately $3.5 million net loss for 2012. Our net loss attributable to common stockholders per common share – basic and diluted decreased from approximately $0.04 per share to $0.02 per share due to the decrease of net loss.

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.

Trend Discussion

We expect revenues for 2013 to further decline due to the unresolved issues regarding the Federal Budget and how deficit reduction will affect the budgets of our Government customers.

As a result, to reduce our cost of revenue, research and development and general and administrative expenses, we have made a strategic decision not to invest internal funds on the further development and advancement of our LGE, LIPC, counter-IED and high voltage systems and have reduced our work force to a level consistent with our expected operations.

Liquidity and Capital Resources

At December 31, 2013, we had approximately $1.1 million of cash and cash equivalents, a decrease of approximately $1.5 million from December 31, 2012. In 2013, we used approximately $1.5 million in operating activities. This amount is comprised primarily of our net loss of $1.4 million and decreases in our accounts payable of $106,000 and accrued expenses and deposits of $104,000, and partially offset by a decrease in accounts receivables of $46,000, the contractors cost settled in disposal of fixed assets of $42,000, depreciation and amortization of $41,000, decrease in inventory of $29,000, noncash stock based compensation of $16,000. Investing activities had $5,000 proceeds from disposal of equipment while financing activities reflected the cash dividend payment of $87,000, resulting in net cash outflow of approximately $1.5 million.

The U.S. Government has significantly reduced defense spending and we do not anticipate receiving significant additional Government funding in the near future. We have completed our Government contracts and do not have any funded Government contracts for future work. We have also developed our USP laser technologies and systems for commercial markets. We have not generated meaningful sales of our commercial systems and we have one existing agreement for the lease of our High Voltage equipment. We are not investing company funds or resources to further develop and enhance our technologies and systems or market our systems other than the submission of proposals for Government contracts. As of March 18, 2014, our backlog was $-0-.

As a result of the decrease in U.S. Government funding, we have significantly reduced our workforce to a level consistent with our expected operations.

Since we are unable to determine if we will be able to obtain any meaningful contracts or generate meaningful revenue or profitable operations in our current businesses, we are considering strategic alternatives, including mergers, the acquisition of one or more businesses or technologies, and/or the disposition of one or more of our existing businesses. Absent the award of a significant new Government contract, we do not expect to continue our current businesses for any meaningful period of time and our continuation as a going concern is dependent upon the success of our strategic efforts.

In their report accompanying our financial statements, our independent auditors stated that our financial statements for the year ended December 31, 2013 were prepared assuming that we would continue as a going concern, and that they have substantial doubt as to our ability to continue as a going concern. Our auditors have noted that our recurring losses from operations and negative cash flow from operations and the concern that we may incur additional losses due to the reduction in Government contract activity raise substantial doubt about our ability to continue as a going concern.

Backlog

At December 31, 2013 and 2012, we had a backlog (i.e., work load remaining on signed contracts) of approximately $25,000 and $26,000, respectively, to be completed within the twelve months following those dates. As of March 18, 2014, our backlog was approximately $-0-.

Contractual Obligations:

The following table summarizes our contractual obligations and other commercial commitments as of December 31, 2012:

	Payment by Period	
	Total	Less than 1 Year
Operating leases	$ 2,898	$ 2,898
Total	$ 2,898	$ 2,898

Not included in the above table are the dividends on our Series A Preferred Stock that are approximately $268,000 each year (approximately $67,000 each quarter), assuming no conversion of the outstanding shares of Series A Preferred Stock into shares of common stock.

Operating Leases

We have, in the past, operated in leased premises under operating leases. Total rent expense on premises amounted to approximately $48,000 and $23,000 for 2013 and 2012, respectively.

Preferred Stock

The Series A Preferred Stock has a liquidation preference of $25.00 per share. The Series A Preferred Stock bears dividends at an initial 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. We have not made the last three quarterly payments in 2013 and, as a result, the dividend rate has increased to 10% per annum and will remain at that level until such failure no longer continues. Dividends in arrears as of February 28, 2014 were $201,000.

The holders of the Series A Preferred Stock have a right to put the stock to the Company for an aggregate amount equal to the liquidation preference ($2.7 million) in the event of a change in control. 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, 2013, 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, 2013, we had no significant off-balance sheet arrangements other than operating leases. For a description of our operating leases, see Note 9 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 Consolidated Financial Statements, the related notes and the Report of Independent Registered Public Accounting Firm thereon, are included in Applied Energetics' 2013 Consolidated 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, 2013. 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 were effective as of December 31, 2013.

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 (”PEO”)and Principal Financial Officer (“PFO”), has conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2013, 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, the PEO and PFO has concluded that our internal control over financial reporting was effective as of December 31, 2013.

This Annual Report on Form 10-K does not include an attestation report of our registered public accounting firm regarding internal controls over financial reporting. Management’s report was not subject to attestation by our registered public accounting firm pursuant to the SEC rules that permit smaller reporting companies to provide only management attestation in annual report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There has been no change in Applied Energetics’ internal control over financial reporting for the quarter ended December 31, 2013 that materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

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
Mark J. Lister	56	Chairman of the Board	2014
Joseph C. Hayden	55	Principal Executive Officer, Principal Financial Officer and Principal Accounting Officer	
George P. Farley	75	Independent Director	2012
John F. Levy	58	Independent Director	2014

Mark J. Lister: Mark J. Lister has served as a member of our Board of Directors since June 2009 and as chairman since July 9, 2012. 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 currently serves s Vice Chairman of the Homeland Security Science and Technology Advisory Committee. He is a former member of 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 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 served as a director of Steel Cloud Inc. a publicly traded company until November 2010. 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.

Joseph C. Hayden: Joseph C. Hayden has been the Principal Executive Officer since April 2009. Mr. Hayden also served as the President from June 2010 through March 2013. Mr. Hayden resigned as President effective April 1, 2013. Previously, he served as the Company's Chief Operating Officer and as Executive Vice President - Programs for Applied Energetics, 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.

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.

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., a natural resource and mining company and a director of China Commercial Credit, Inc., a privately held micro credit company that provides direct loans and loan guarantee services in China. Mr. Levy was formerly a director of Brightpoint, Inc., Take-Two Interactive Software, Inc., PNG Ventures, Inc. and Ciocia, 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.

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:

- 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.
- 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. 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 a consulting firm he founded.

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

4585 South Palo Verde Road, Suite 405

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

ITEM 11. EXECUTIVE COMPENSATION

Summary Compensation Table

The following table discloses, for the periods presented, the compensation for the person who served as our Principal Executive Officer, our Chief Financial Officer and our Chief Operating Officer for the years ended December 31, 2013, and 2012 (the "Named Executive").

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary (1)	All Other Compensation (2)	Total
Joseph C. Hayden	2013	$133,913	$ 10	$133,923
Principal Executive Officer, Principal Financial Officer and Principal Accounting Officer	2012	$196,083	$ 262	$196,345

(1) Mr. Hayden's annual salary at January 1, 2013 was $195,500. On April 12, 2013, we entered into a consulting agreement effective April 1, 2013 with SVJ Enterprises LLC ("SVJ"), an affiliate of Mr. Hayden, where Mr. Hayden is to continue to serve as the company's principal executive officer, principal financial officer and principal accounting officer and SVJ will be compensated at the rate of $250 per hour, up to a maximum of 10 hours per week, for Mr. Hayden's services.

(2) The amounts shown in the "All Other Compensation" column are attributable the dollar value of life insurance premiums paid by us for all named executive officers. The amount reported for 2013 represents this benefit paid on

Mr. Hayden's behalf prior to entering into a contracting agreement with SVJ.

Employment Agreements for Named Executive Officers

On April 12, 2013, Applied Energetics, Inc. (the "Company") entered into a consulting agreement effective as of April 1, 2013, with SVJ, an affiliate of Joseph Hayden, its principal executive officer ("PEO") and principal financial and accounting officer ("PFO/PAO"). Pursuant to the agreement, SVJ cause Mr. Hayden to continue to serve as the Company's PEO and PFO/PAO and SVJ will be compensated at the rate of $250 per hour, up to a maximum of 10 hours per week, for Mr. Hayden's services. The agreement provides that SVJ must obtain the advance approval of the Company's CEO or Chairman of the Board to exceed ten hours per week.

Payments upon Termination or Change-In-Control

Name	Without Cause Termination	For Good Reason Resignation	For Cause Termination or Voluntary Resignation	Change in Control	Termination Following Change in Control (1)
Joseph C. Hayden	$ -	$ -	$ -	$ -	$ 30,000

(1) In the agreement with SVJ for Mr. Hayden's services, it was agreed that in the event that a Change of Control occurs and the company terminates the agreement prior to the expiration of its term, the company shall pay to Consultant a termination fee in the amount of $30,000. The term "Change of Control" means a consolidation or merger with or into (whether or not the Company is the surviving corporation) any other corporation or other entity and as a result, the stockholders of the Company immediately prior to the termination own less than 50% of the shares of capital stock of the surviving corporation entitled to vote at the election of directors.

Director Compensation

The following table discloses our director compensation for the year ended December 31, 2013:

Name	Fees Earned or Paid in Cash	Stock Awards (1)	Total
Mark J. Lister	$ 33,303	$ -	$33,303
George P. Farley	$ 30,371	$ -	$30,371
John F. Levy	$ 26,429	$ -	$26,429

(1) The amounts shown in the "Stock Awards" column represent the aggregate grant date fair value in 2013 related to stock awards, computed in accordance with FASB ASC Topic 718. For a discussion of valuation assumptions, see Note 7 to our 2013 Consolidated Financial Statements.

As of January of 2013, the annual cash compensation for independent directors was follows: Mr. Lister $63,750 and Messrs. Farley and Levy $50,000. Effective March 18, 2013, the Directors of the Company agreed to reduce their annual director compensation to $25,000 for Messrs. Lister and Farley and to $20,000 for Mr. Levy.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION:

During the fiscal year ended December 31, 2013, none of our executive officers served on the Board of Directors or the Compensation Committee of any other company whose executive officers also serve on our Board of Directors or our Compensation Committee.

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

The following table sets forth information regarding the beneficial ownership of our Common Stock, based on information provided by the persons named below in publicly available filings, as of March 18, 2014:

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

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Unless otherwise indicated, the address of each beneficial owner is care of Applied Energetics, 4585 South Palo Verde Road, Suite 405, Tucson, Arizona 85714. Unless otherwise indicated, the company believes that all persons named in the following table have sole voting and investment power with respect to all shares of common stock that they beneficially own.

For purposes of this table, a person is deemed to be the beneficial owner of the securities if that person has the right to acquire such securities within 60 days of March 18, 2014 upon the exercise of options or warrants. In determining the percentage ownership of the persons in the table below, we assumed in each case that the person exercised all options which are currently held by that person and which are exercisable within such 60 day period, but that options and warrants held by all other persons were not exercised, and based the percentage ownership on 91,735,662 shares outstanding on March 18, 2014.

Name of Beneficial Owner	Number of Shares Beneficially Owned (1)		Percentage of Shares Beneficially Owned (1)	
Superius Securities Group Inc. Profit Sharing Plan	8,535,997	(2)	9.3	%
Joseph C. Hayden	5,603,668		6.1	%
Mark J. Lister	75,000		*	
John F. Levy	37,500		*	
George P. Farley	0	(3)	*	
All directors and executive officers as a group (5 persons)	5,716,168		6.2	%

* Less than 1%

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

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

(3) Mr. Farley denies beneficial ownership of the common shares and common shares issuable upon exercise of options he transferred to various LLCs.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table details information regarding our existing equity compensation plans as of December 31, 2013:

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	449,500	$ 0.44	10,852,616
Equity compensation plans not approved by security holders	-	$ -	-
Total	449,500	$ 0.44	10,852,616

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

The 2004 Stock Incentive Plan (“2004 Plan”), which provides for the grant of any or all of the following types of awards: (1) stock options, which may be either incentive stock options or non-qualified stock options, (2) restricted stock, (3) deferred stock and (4) other stock-based awards. A total of 3,000,000 shares of common stock were originally reserved for distribution pursuant to the 2004 Plan. On June 28, 2005, the stockholders approved an amendment to the 2004 Plan to (i) increase the number of shares of the company's common stock, $.001 par value, authorized for issuance under the 2004 Plan by 2,000,000 shares from 3,000,000 shares to 5,000,000 shares, and (ii) set the maximum number of shares of common stock which may be issued upon the exercise of incentive stock options at 3,000,000 shares. As of December 31, 2013, options to purchase 317,500 shares were outstanding under this plan. Additionally, as of December 31, 2013, there were no unvested restricted stock units outstanding under this plan. Approximately 2.6 million shares were available for grant under this plan as of December 31, 2013.

The 2007 Stock Incentive Plan (“2007 Plan”), which provides for the grant of any or all of the following types of awards: (1) stock options, which may be either incentive stock options or non-qualified stock options, (2) restricted stock, (3) deferred stock, (4) stock appreciation rights, and (5) other stock-based awards. A total of 10,000,000 shares of common stock have been reserved for distribution pursuant to the 2007 Plan provided, however, that the maximum number of shares available for award or grant during the first five years of the 2007 Plan shall be an aggregate of 5,000,000 shares; and provided further that the maximum number of shares available for award or grant during any consecutive twelve month period shall be 1,000,000 shares during the first two years of the 2007 Plan and 2,000,000 shares during the third through fifth years of the 2007 Plan. The five-year limitation period ended September 10, 2012. As of December 31, 2013, options to purchase 132,000 shares were outstanding under this plan. As of December 31, 2013, 7,425 restricted stock grants remain outstanding under the plan. As of December 31, 2013, approximately 8.2 million shares were available for grant from this plan.

We have, from time to time, also granted non-plan options and other equity-based awards to certain officers, directors, employees and consultants. No inducement grants as defined were made during 2013, nor are any outstanding from previous years.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Transactions with Related Parties

Except as disclosed herein, no director, executive officer, stockholder holding at least 5% of shares of our common stock, or any family member thereof, had any material interest, direct or indirect, in any transaction, or proposed transaction since the year ended December 31, 2013.

Review, Approval or Ratification of Transactions with Related Persons

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

Director Independence

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

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES:

The following is a summary of the fees billed to the company by BDO USA, LLP for professional services rendered for the years ended December 31, 2013 and 2012.

	2013	2012
Audit Fees	$67,029	$125,721
Tax Fees	$15,000	$18,500

Fees for audit services include fees associated with the annual audit of the company and its subsidiaries, the review of our quarterly reports on Form 10-Q. Tax fees include tax compliance, tax advice, research and development credits and tax planning related to federal and state tax matters.

Pre-Approval Policies and Procedures

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

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

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

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

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Exhibits:

EXHIBIT NUMBER	DESCRIPTION
2.1	Amended and Restated Plan and Agreement of Merger entered into as of March 17, 2004, by and among U.S. Home & Garden, Inc. (“USHG”), Ionatron Acquisition Corp., a wholly-owned subsidiary of USHG, Robert Kassel (for purposes of Sections 5.9, 6.2(d), 6.2(j), 9.4 and 10.10 only), Fred Heiden (for purposes of Section 9.4 only), and Ionatron, Inc. and Robert Howard, Stephen W. McCahon, Thomas C. Dearmin and Joseph C. Hayden (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on March 24, 2004).
3.1	Certificate of Incorporation, as amended, (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-KSB for the fiscal year ended June 30, 1995).
3.2	Certificate of Amendment of Certificate of Incorporation of the Registrant filed with the Secretary of State of the State of Delaware on April 29, 2004 (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-Q for the quarterly period ended March 31, 2004).
3.3	Certificate of Elimination of the 10% Series A Convertible Preferred Stock of the Registrant (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on October 28, 2005).
3.4	Certificate of Designation of the 6.5% Series A Redeemable Convertible Preferred Stock of the Registrant (incorporated by reference to the comparable exhibit filed with the Registrant’s 8-K filed with the SEC on October 28, 2005).
3.5	Certificate of Ownership and Merger of Applied Energetics, Inc. into Ionatron, Inc. (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on February 20, 2008).
3.6	Amended and Restated By-laws of the Registrant (incorporated by reference to Exhibit 3 of the Registrant’s Form 10-Q for the Quarter ended June 30, 2007.
3.7	Certificate of Amendment to Certificate of Incorporation filed with the Secretary of State of the State of Delaware on September 10, 2007.
4.1	Form of certificate evidencing Common Stock, $.001 par value, of the Registrant
10.1	2004 Stock Incentive Plan (incorporated by reference to Appendix B to the Registrant’s Proxy Statement on Schedule 14A filed with the SEC on May 25, 2005).
10.2	Form of 2004 Stock Incentive Plan Non-Qualifying Stock Option Agreement for Directors (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-Q for the quarterly period ended June 30, 2005).
10.3	2007 Stock Incentive Plan (as amended).
10.4	Applied Energetics, Inc. consulting agreement with SVJ Enterprises LLC effective April 1, 2013 (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 8-K filed with the SEC on April 17, 2013)
21	Subsidiaries (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-K for the year ended December 31, 2006)
23.1	Consent of BDO USA, LLP
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Principal Executive Officer and Principal Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.1	Compensation Committee Charter (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-K for the year ended December 31, 2010)
99.2	Corporate Governance and Nominating Committee Charter (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-K for the year ended December 31, 2009)
99.3	Audit Committee Charter (incorporated by reference to the comparable exhibit filed with the Registrant’s Form 10-K for the year ended December 31, 2009

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on the 10th day of April, 2014.

APPLIED ENERGETICS, INC.

By /s/ Joseph C. Hayden
Joseph C. Hayden
Principal Executive Officer, Principal Financial Officer and Principal Accounting Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on the 11th day of April, 2014 by the following persons on behalf of the registrant and in the capacities indicated.

Name	Title
/s/ Mark J. Lister Mark J. Lister	Chairman of the Board
/s/ George P. Farley George P. Farley	Director
/s/ John F. Levy John F. Levy	Director
/s/ Joseph C. Hayden Joseph C. Hayden	Principal Executive Officer, Principal Financial Officer and Principal Accounting Officer

APPLIED ENERGETICS, INC.

FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2013 and 2012

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Applied Energetics, Inc.

Tucson, Arizona

We have audited the accompanying consolidated balance sheets of Applied Energetics, Inc. as of December 31, 2013 and 2012 and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Applied Energetics, Inc. at December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended**,** in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring losses from operations and expects losses from operations to continue in 2014 due to the reduction of government contract activity that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ BDO USA, LLP

Phoenix, Arizona

April 14, 2014

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APPLIED ENERGETICS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31,

	2013	2012
Revenue	$42,686	$1,335,421
Cost of revenue	35,852	1,148,906
Gross profit	6,834	186,515
Operating expenses:		
General and administrative	1,391,590	2,757,510
Selling and marketing	37,511	776,054
Research and development	-	157,313
Total operating expenses	1,429,101	3,690,877
Operating loss	(1,422,267)	(3,504,362)
Other income (expense):		
Interest expense	-	(1,651)
Interest income	4,847	2,536
Total other income (expense)	4,847	885
Loss before provision for income taxes	(1,417,420)	(3,503,477)
Provision for income taxes	-	-
Net loss	(1,417,420)	(3,503,477)
Preferred stock dividends	(236,411)	(174,155)
Net loss attributable to common stockholders	$(1,653,831)	$(3,677,632)
Net loss attributable to common stockholders per common share – basic and diluted	$(0.02)	$(0.04)
Weighted average number of common shares outstanding, basic and diluted	91,735,662	91,719,288

See accompanying notes to consolidated financial statements.

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APPLIED ENERGETICS, INC.

CONSOLIDATED BALANCE SHEETS

	DECEMBER 31, 2013	2012
ASSETS		
Current assets		
Cash and cash equivalents	$1,079,336	$2,622,142
Accounts receivable	1,875	47,964
Inventory - net	37,953	66,884
Prepaid expenses	97,274	102,610
Total current assets	1,216,438	2,839,600
Property and equipment - net	6,984	81,623
TOTAL ASSETS	$1,223,422	$2,921,223
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$11,359	$116,930
Accrued expenses	217,138	76,188
Accrued compensation	44,990	140,783
Total current liabilities	273,487	333,901
Total liabilities	273,487	333,901
Commitments and contingencies		
Stockholders' equity		
Series A convertible preferred stock, $.001 par value, 2,000,000 shares authorized and 107,172 shares issued and outstanding at December 31, 2013 and 2012 (Liquidation preference $2,679,300)	107	107
Common stock, $.001 par value, 500,000,000 shares authorized; 91,735,662 shares issued and outstanding at December 31, 2013 and December 31, 2012	91,736	91,736
Additional paid-in capital	79,234,745	79,218,301
Accumulated deficit	(78,376,653)	(76,722,822)
Total stockholders' equity	949,935	2,587,322
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,223,422	$2,921,223

See accompanying notes to consolidated financial statements.

APPLIED ENERGETICS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Preferred Stock		Common Stock		Additional Paid-in	Accumulated	Total Stockholders'
	Shares	Amount	Shares	Amount	Capital	Deficit	Equity
Balance as of December 31, 2011	107,172	$ 107	91,670,192	$91,670	$79,155,518	$(73,045,190)	$6,202,105
Stock issued under equity incentive plans	-	-	65,470	66	(66)	-	-
Stock-based compensation expense	-	-	-	-	62,849	-	62,849
Preferred stock dividends	-	-	-	-	-	(174,155)	(174,155)
Net loss for the year ended December 31, 2012	-	-	-	-	-	(3,503,477)	(3,503,477)
Balance as of December 31, 2012	107,172	$ 107	91,735,662	$91,736	$79,218,301	$(76,722,822)	$2,587,322
Sale of common stock	-	-	-	-	14	-	14
Stock-based compensation expense	-	-	-	-	16,430	-	16,430
Preferred stock dividends	-	-	-	-	-	(236,411)	(236,411)
Net loss for the year ended December 31, 2013	-	-	-	-	-	(1,417,420)	(1,417,420)
Balance as of December 31, 2013	107,172	$ 107	91,735,662	$91,736	$79,234,745	$(78,376,653)	$949,935

See accompanying notes to consolidated financial statements.

APPLIED ENERGETICS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31,

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(1,417,420)	$(3,503,477)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	40,831	192,970
Loss on sale of land and building	-	720,000
Gain on equipment disposal	(13,392)	(118,967)
Contractor cost setteled in disposal of fixed assets	42,000	-
Noncash stock based compensation expense	16,430	62,849
Changes in assets and liabilities:		
Accounts receivable	46,089	446,780
Other receivable	-	99,447
Inventory	28,931	74,793
Prepaid expenses and other assets	5,337	351,918
Accounts payable	(105,571)	(201,400)
Billings in excess of costs	-	(2,152)
Accrued expenses and deposits	(104,178)	(754,153)
Net cash used in operating activities	(1,460,943)	(2,631,392)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	-	(15,141)
Proceeds from disposal of building and equipment	5,200	1,505,695
Net cash provided by investing activities	5,200	1,490,554
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from sale of common stock	14	-
Payment of cash dividends	(87,077)	(174,155)
Net cash used in financing activities	(87,063)	(174,155)
Net decrease in cash and cash equivalents	(1,542,806)	(1,314,993)
Cash and cash equivalents, beginning of period	2,622,142	3,937,135
Cash and cash equivalents, end of period	$1,079,336	$2,622,142
Suplemental Cash Flow Information		
Cash paid for interest	$-	$-
Cash paid for income taxes	$-	$-
Preferred dividends accrued and unpaid	$149,334	$-

See accompanying notes to consolidated financial statements.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

Basis of Presentation

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

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. For the year ended December 31, 2013, the company incurred a net loss of $1.4 million, had negative cash flows from operations of $1.5 million and may incur additional future losses due to the reduction in Government contract activity. These matters raise substantial doubt as to the company’s ability to continue as a going concern.

Although there can be no assurance, management believes it will be successful in the development and sales of their USP laser systems and high voltage systems, securing new contracts from Department of Defense customers and obtaining additional financing necessary to fund operating shortfalls. The financial statements do not include any adjustments relating to the recoverability of assets and the amount or classification of liabilities that might be necessary should the company be unable to continue as a going concern.

Nature of Business

Applied Energetics designs, develops and manufactures solid state Ultra Short Pulse (“USP”) lasers for commercial applications and applied energy systems for commercial and military applications. Through our technology development efforts, we have gained expertise and proprietary knowledge in high performance lasers and high-voltage electronics.

Use of Estimates

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

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Revenue Recognition

A majority of revenue under long-term government contracts is recorded under the percentage of completion method. Revenue, billable monthly under cost plus fixed fee contracts, is recorded as costs are incurred and includes estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. Costs include direct labor, direct materials, subcontractor costs and manufacturing and administrative overhead allowable under the contract. General and administrative expenses allowable under the terms of contracts are allocated per contract, depending on its direct labor and material proportion to total direct labor and material of all contracts. As contracts can extend over one or more accounting periods, revisions in earnings estimated during the course of work are reflected during the accounting period in which the facts become known. When the current contract estimate indicates a loss, a provision is made for the total anticipated loss in the current period. We do not generally provide an allowance for returns from our government customers because our customer agreements do not provide for a right of return.

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

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

Net Loss Attributable to Common Stockholders

Basic loss per common share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding for the period before giving effect to stock options, stock warrants, restricted stock units and convertible securities outstanding, which are considered to be dilutive common stock equivalents. Diluted net loss per common share is calculated based on the weighted average number of common and potentially dilutive shares outstanding during the period after giving effect to dilutive common stock equivalents. Contingently issuable shares are included in the computation of basic loss per share when issuance of the shares is no longer contingent. The number of options, restricted stock units and our Series A Convertible Preferred Stock, which were not included in the computation of earnings per share because the effect was antidilutive, was 564,097 and 1,471,899 for the years ended December 31, 2013 and 2012, respectively.

Fair Value of Current Assets and Liabilities

The carrying amount of accounts receivable and accounts payable approximate fair value due to the short maturity of these instruments.

Cash and Cash Equivalents

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

Accounts Receivable and Allowance for Doubtful Accounts

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

We do not generally provide an allowance for receivables from the Government. We have non-Government customers for which we provide for potentially uncollectible accounts receivable by use of the allowance method. The allowance is provided based upon a review of the individual accounts outstanding, and the company’s prior history of uncollectible accounts receivable. As of December 31, 2013 and 2012, we believe all receivable balances to be fully collectible and accordingly, have no allowance for doubtful accounts at such dates.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Inventory

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

Property and Equipment

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

On September 28, 2012, we sold our principal office, manufacturing, storage, and primary research and development facility in Tucson, Arizona and its contents for $1.46 million. In the sale transaction, we disposed of assets with a net book value of $2.094 million, and incurred transaction costs of $86,000. The loss on the sale of the building and contents was approximately $720,000. We also disposed of other equipment which resulted in a gain of approximately $119,000.

Computer Software Development Costs

In general, direct development costs associated with internal-use computer software are capitalized as fixed assets and include external direct costs of material and services and payroll costs for employees devoting time to the software projects, where applicable. Costs incurred during the preliminary project stage, as well as for maintenance and training, are expensed as incurred. Depreciation expense relative to capitalized computer software development costs was approximately $-0- and $64,788 for 2013 and 2012, respectively.

Long-Lived Assets

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

We assess the recoverability of such long-lived assets by determining whether the amortization of the balances over their remaining lives can be recovered through undiscounted future operating cash flows. The amount of impairment, if any, is measured based on projected discounted future operating cash flows. The assessment of the recoverability of long-lived assets will be impacted if estimated future operating cash flows are not achieved.

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. Our valuation allowance is currently 100% of our assets.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

Share-Based Payments

Employee stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. The fair value of each option grant is estimated at the date of grant using the Black-Scholes-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 on common stock, (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.

Significant Concentrations and Risks

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

Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts

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

Research and Development Costs

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

NOTE 2 – NEW ACCOUNTING STANDARDS

The company has reviewed issued accounting pronouncements and plans to adopt those that are applicable to it. The company does not expect the adoption of any other pronouncements to have an impact on its results of operations or financial position.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - ACCOUNTS RECEIVABLE

Our accounts receivable balance as of December 31, 2013 and 2012 included contract receivables related to completed and in progress contracts, and costs and estimated earnings on uncompleted contracts. Costs and estimated earnings on uncompleted contracts represent amounts that are billable under the terms of contracts at the end of the year, were invoiced in the following year and are generally expected to be collected within a year.

Accounts receivable consist of the following as of:

	December 31, 2013	December 31, 2012
Contracts receivable	$1,875	$46,221
Cost and estimated earnings (uncompleted contracts)	-	1,743
Accounts receivable, net	$1,875	$47,964

Contracts at December 31, 2013 are expected to be collected within a year. There are no claims or unapproved change orders included in contract receivables at December 31, 2013 and 2012.

Costs and Estimated Earnings on Uncompleted Contracts

	December 31, 2013	December 31, 2012
Costs incurred on uncompleted contracts	$6,030,151	$6,350,706
Estimated earnings	460,173	601,755
Total billable costs and estimated earnings	6,490,324	6,952,461
Less:		
Billings to date	6,490,324	6,950,718

Total	$-	$1,743
Included in accompanying balance sheet**:**		
Unbilled costs and estimated earnings on uncompleted contracts included in accounts receivable	$-	$1,743
Billings in excess of costs and estimated earnings on uncompleted contracts	-	-
Total	$-	$1,743

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APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – INVENTORIES

Our inventories consist of the following at:

	December 31,	
	2013	2012
Raw materials	$37,953	$66,719
Work-in-process		165
Provision for loss on project	-	-
Total inventory	$37,953	$66,884

Inventories include material, direct labor and related manufacturing administrative overhead and are stated at the lower-of-cost (determined on a weighted average basis) or market for raw materials and work-in-process inventory. When actual contract cost and the estimate to complete exceed the estimated contract revenues, a loss provision is recorded. Due to the nature of our inventory, we analyze inventory on an item-by-item basis compared to future usage and sales for obsolescence quarterly. As of December 31, 2013, management did not believe an obsolescence reserve was necessary based on this analysis. As of December 31, 2012, management created an obsolescence reserve of approximately $15,000 based on this analysis.

NOTE 5 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following as of:

	December 31,	
	2013	2012
Leasehold improvements	15,141	15,141

Equipment	1,728,270	1,898,920
Furniture	5,333	5,333
Software	778,379	801,498
Total	2,527,123	2,720,892
Less accumulated depreciation and amortization	(2,520,139)	(2,639,269)
Property and equipment - net	$6,984	$81,623

Property and equipment are depreciated over 3 to 5 years using the straight line, half year convention. The number of years is dependent upon the useful life of the equipment. Depreciation expense was approximately $41,000 and $193,000 for the years ended December 31, 2013 and 2012, respectively. Depreciation expense is included in general and administrative expense.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – ACCRUED EXPENSES

Accrued expenses consist of the following as of:

	December 31,	
	2013	2012
Accrued professional fees	$31,144	$31,500
Dividends payable	177,876	28,542
Other	8,118	16,146
Total accrued expenses	$217,138	$76,188

NOTE 7 – STOCKHOLDERS' EQUITY

Preferred Stock

As of December 31, 2013 and 2012, there were 107,172 shares of Series A Redeemable Convertible Preferred Stock (the "Series A Preferred Stock") outstanding. The company's Board of Directors did not declare the dividends due August 1, 2013 and November 1, 2013. Accordingly, the company did not pay these dividends. Dividend arrearages as of December 31, 2013 are approximately $134,000.

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

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

Dividends on our Preferred Stock are payable quarterly on the first day of February, May, August and November, in cash or shares of Common Stock, at our discretion. We declared and paid dividends on our 6.5% Series A Preferred Stock in May, August and November, 2012 and February and May, 2013.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the payment of dividends in 2012, we paid approximately $174,000, and accrued approximately $29,000 as of December 31, 2012 which was paid in cash on February 1, 2013.

Share-Based Payments

Applied Energetics adopted an Amended and Restated 2007 Stock Incentive Plan ("2007 Plan") and a 2004 Stock Incentive Plan as amended ("2004 Plan") both of which provides for the grant of any or all of the following types of awards: (1) stock options, (2) restricted stock, (3) deferred stock, (4) stock appreciation rights, and (5) other stock-based awards, including restricted stock units, for periods up to 10 years. Stock options granted under the plans are generally for a fixed number of shares to employees and directors with an exercise price equal to the fair market value of the shares at the date of grant. Options granted to employees will generally vest over two to four years. Most options granted have a contractual life of 5 years from the grant date. Restricted stock granted under the plans to employees generally vest immediately and/or over a period of up to four years. Some restricted stock granted under the plans vest only upon meeting certain departmental or company-wide performance goals. Both restricted stock and options granted to non-employee directors generally vest immediately on the date of grant. We have, from time to time, also granted non-plan options to certain officers, directors and employees. Total stock-based compensation expense for grants to officers, employees and consultants was approximately $16,000 and $63,000 for the years ended December 31, 2013 and 2012, respectively, which was charged to general and administrative expense.

At December 31, 2013 and 2012, there were outstanding options to purchase 520,000 and 1.2 million, respectively, of common stock. There are 7,425 unvested restricted stock units outstanding as of December 31, 2013. As of December 31, 2013 and 2012, there were no unvested restricted stock awards outstanding.

The following table sets forth information regarding awards under our 2004 and 2007 Stock Incentive Plans:

As of December 31, 2013

	Share Grants Approved	Options Outstanding	Restricted Stock Awards Outstanding	Restricted Stock Units Outstanding	Shares Available for Award
2004 Stock Incentive Plan	5,000,000	317,500	-	-	2,616,974
2007 Stock Incentive Plan	10,000,000	202,000	-	7,425	8,165,642
Total		519,500	-	7,425	10,782,616

On June 28, 2005, our stockholders approved an amendment to the company's 2004 Plan to (i) increase the number of shares of the company's common stock, $.001 par value, authorized for issuance under the 2004 Plan by 2,000,000 shares from 3,000,000 shares to 5,000,000 shares, and (ii) set the maximum number of shares of common stock which may be issued upon the exercise of incentive stock options at 3,000,000 shares. As of December 31, 2013 and 2012, options to purchase 317,500 and 695,500 shares, respectively, were outstanding under this plan. Additionally, as of December 31, 2013 and 2012, there were no unvested restricted stock units outstanding under this plan.

APPLIED ENERGETICS, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

On September 10, 2007, the stockholders of Applied Energetics approved the adoption of the company's 2007 Plan. A total of 10,000,000 shares of common stock have been reserved for distribution pursuant to the 2007 Plan; provided, however, that the maximum number of shares available for award or grant during the first five years of the 2007 Plan shall be an aggregate of 5,000,000 shares; and provided further that the maximum number of shares available for award or grant during any consecutive twelve month period shall be 1,000,000 shares during the first two years of the 2007 Plan and 2,000,000 shares during the third through fifth years of the 2007 Plan. The five-year limitation period ended September 10, 2012. As of December 31, 2013 and 2012, options to purchase 132,000 and 476,666 shares, respectively, were outstanding under this plan. There were 7,425 and 76,458 unvested restricted stock units outstanding as of December 31, 2013 and 2012, respectively. As of December 31, 2013 and 2012 there were no restricted stock awards outstanding. Grants from the 2007 Plan can be either service based, where the grant vests with the passage of time, or performance based, where the grant vests based on the attainment of a pre-defined company or departmental goal.

There are 10,782,616 aggregate shares available for grant from the Stock Incentive Plans as of December 31, 2013.

The fair value of restricted stock and restricted stock units was estimated using the closing price of our common stock on the date of award and fully recognized upon vesting.

No options were granted in 2013 or 2012.

The following table summarizes the activity of our stock options for the years ended December 31, 2013, and 2012:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 2011	3,823,260	$ 0.52
Granted	-	$ 0.00
Exercised	-	$ 0.00
Forfeited or expired	(2,651,094)	$ 0.53
Outstanding at December 31, 2012	1,172,166	$ 0.51

Granted	-	$	0.00
Exercised	-	$	0.00
Forfeited or expired	(652,666)	$	0.55
Outstanding at December 31, 2013	519,500	$	0.47
Exercisable at December 31, 2013	519,500	$	0.47

As of December 31, 2013 and December 31, 2012, the aggregate intrinsic value (amount by which Applied Energetics' closing stock price on the last trading day of the year exceeds the exercise price of the option) of options outstanding was $0, as the exercise price was greater than the market price. As of December 31, 2013 and 2012, the weighted average remaining contractual life of options outstanding and options exercisable was 0.57 and 1.72 years, respectively. At December 31, 2013, there was approximately $0 of unrecognized compensation costs related to unvested stock options, net of estimated forfeitures.

The following table summarizes the activity of our restricted stock units and restricted stock grants for the years ended December 31, 2013 and 2012:

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	Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2011	242,635	$ 0.94
Granted	-	$ 0.00
Vested	(76,510)	$ 0.96
Forfeited	(89,667)	$ 1.02
Unvested at December 31, 2012	76,458	$ 0.83
Granted	-	$ -
Vested	(38,228)	$ 0.83
Forfeited	(30,805)	$ 0.83
Unvested at December 31, 2013	7,425	$ 0.83

As of December 31, 2013, there was approximately $2,000 of unrecognized stock-based compensation related to unvested restricted stock, net of estimated forfeitures, which we expect to recognize over a weighted-average period of 0.21 years. Of the 7,425 restricted stock units unvested at December 31, 2013, all are expected to vest with the filing of the Company’s Annual Reports with the Securities and Exchange Commission for the year 2013.

Compensation expense recorded for shares and options delivered to non-employee consultants for the years ended December 31, 2013 and 2012 was approximately $0 and $0, respectively, which was charged to operating expenses with offsetting entries to additional paid-in capital or prepaid assets.

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NOTE 8– SIGNIFICANT CUSTOMERS

The majority of our customers are either the Government or contractors to the Government and represent 61% and 90% of our revenue for 2013 and 2012, respectively. Government sourced customers represent approximately -0-% and 83% of our account receivable balances as of December 31, 2013 and 2012, respectively.

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Operating Leases

In August 2012, we entered into two 1-year lease agreements to lease office and manufacturing space and to lease storage space in Tucson, Arizona. In May 2013, these leases were changed to month-to-month.

In September 2012, we closed on the sale of the office, manufacturing and storage facility that we have occupied since our inception in 2002. The building represented a sizable asset which was much larger than that required to support our present operations.

Rent expense was approximately $48,000 and $23,000 for 2013 and 2012, respectively.

At December 31, 2013, we had approximately $3,800 in future minimum lease payments due in less than a year.

Guarantees

We agree to indemnify our officers and directors for certain events or occurrences arising as a result of the officers or directors serving in such capacity. The maximum amount of future payments that we could be required to make under these indemnification agreements is unlimited. However, we maintain a director's and officer’s liability insurance policy that limits our exposure and enables us to recover a portion of any future amounts paid. As a result, we believe the estimated fair value of these indemnification agreements is minimal because of our insurance coverage and we have not recognized any liabilities for these agreements as of December 31, 2013 and 2012.

Litigation

On or about January 14, 2010, NewOak Capital Markets LLC ("NewOak"), formerly known as J. Giordano Securities, LLC, the placement agent for our October 2005 private placement of preferred stock, filed a Statement of Claim against us with Financial Industry Regulatory Authority ("FINRA"). NewOak alleged that we made material misrepresentations between May 2005 and May 10, 2006 concerning the status of our products.

On July 13, 2011 the United States Court of Appeals, Second Circuit dismissed the arbitration.

On December 14, 2011, NewOak filed a lawsuit in the United States District Court for the Southern District of New York against the Registrant and two former officers and directors. NewOak alleges that the Registrant made material misrepresentations prior to the October 2005 private placement concerning the development of its counter-IED products.

On February 9, 2012, the litigation with NewOak was dismissed with prejudice on February 16, 2012 pursuant to a settlement agreement which required the payment of $200,000. The $200,000 payment was accrued as of December 31, 2011 and paid in 2012, net of insurance proceeds of $50,000.

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 – INCOME TAXES

The reconciliation of the difference between income taxes at the statutory rate and the income tax provision for the years ended:

	December 31, 2013	December 31, 2012
Computed tax at statutory rate	$(481,923)	$(1,188,632)
State taxes	(98,365)	269,447
Change in valuation allowance	574,520	918,139
Other	5,768	1,046
Provision (benefit) for taxes	$-	$-

Deferred tax assets (liabilities) consist of the following:

	December 31, 2013	December 31, 2012
Deferred Tax Assets:		
Accruals and reserves	$11,003	$58,080
Depreciation and amortization	139,045	256,353
Tax credit carryforwards	579,497	579,497
Net operating loss	20,910,696	20,871,772
Goodwill amortization	233,485	274,111
ASC 718 stock compensation	44,370	425,532
Valuation allowance	(21,918,096)	(22,465,345)
Total deferred tax assets	$-	$-

We believe that sufficient uncertainty exists regarding the future realization of our deferred tax assets and thus a full valuation allowance is required. The valuation allowance for the year ended December 31, 2013 increased by approximately $72,000 due to changes in deferred tax assets.

As of December 31, 2013, we have cumulative federal and Arizona net operating loss carryforwards of approximately $57 million and $23 million, respectively, which can be used to offset future income subject to taxes. Federal net operating loss carryforwards begin to expire in 2020. Arizona net operating loss carryforwards begin to expire in 2013. Included in federal net operating loss carryforwards is approximately $27.1 million from USHG related to pre-merger losses. In addition, approximately $7 million of the federal net operating loss carryforwards are related to stock based compensation that will be credited to additional paid in capital when realized. We also have pre-merger federal capital loss carryforwards of approximately $520,000.

As of December 31, 2013, we had cumulative unused research and development tax credits of approximately $239,000 and $340,000, which can be used to reduce future federal and Arizona income taxes, respectively. As of December 31, 2012, we have cumulative unused federal minimum tax credit carryforwards from USHG of approximately $244,000. The federal minimum tax credit carryforwards are not subject to expiration under current federal tax law.

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

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

Balance at December 31, 2011	9,635,824
Additions related to prior year tax positions	-
Additions related to current year tax positions	-
Reductions related to prior year tax positions and settlements	-
Balance at December 31, 2012	$9,635,824
Additions related to prior year tax positions	-
Additions related to current year tax positions	-
Reductions related to prior year tax positions and settlements	-
Balance at December 31, 2013	$9,635,824

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

The company considers the U.S. and Arizona to be major tax jurisdictions. As of December 31, 2013, for federal tax purposes the tax years 2012 and 2013 and for Arizona the tax years 2005 through 2013 remain open to examination. The company currently does not expect any material changes to unrecognized tax positions within the next twelve months.

We recognize interest and penalties related to unrecognized tax benefits in income tax expense. As of December 31, 2013 and 2012, we had no accrued interest or penalties related to our unrecognized tax benefits.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11 – QUARTERLY OPERATING RESULTS (UNAUDITED)

Quarterly operating results for 2013 and 2012 were as follows:

	1st	2nd	3rd	4th
2013				
Revenues	$34,457	$4,263	$2,091	$1,875
Gross profit (loss)	5,563	(2,695)	2,091	1,875
Operating loss	(573,868)	(385,077)	(260,447)	(202,875)
Net loss attributable to common stockholders	$(616,754)	$(426,347)	$(341,754)	$(210,441)
Weighted average number of shares outstanding, basic and diluted	91,735,662	91,735,662	91,735,662	91,735,662
Basic and diluted net loss per share	$(0.01)	$(0.005)	(0.004)	$(0.002)
2012				
Revenues	$399,207	$504,307	$311,992	$119,915
Gross profit (loss)	34,140	114,784	48,305	(10,714)
Operating loss	(1,189,615)	(1,403,010)	(366,259)	(545,478)
Net loss attributable to common stockholders	$(1,234,412)	$(1,446,159)	$(409,606)	$(587,455)
Weighted average number of shares outstanding, basic and diluted	91,670,192	91,735,440	91,735,247	91,735,662
Basic and diluted net loss per share	(0.013)	(0.016)	(0.004)	$(0.01)

NOTE 13 – SUBSEQUENT EVENT

The Company’s management has evaluated subsequent events occurring after December 31, 2013, the date of our most recent balance sheet, through the date our financial statements were issued.

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